Provincial Tax Reforms:

OPTIONS AND OPPORTUNITIES

By
DAVID W. CONKLIN AND
FRANCE ST-HILAIRE

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Foreword

The 1987 White Paper on Tax Reform indicated the Canadian government's intention to implement sweeping changes to the personal, corporate and federal sales tax systems. Subsequent proposals have been modified frequently in response to a wide range of critical commentary. Provincial governments have been caught up in this reform debate for a number of reasons. Some provinces have questioned the appropriateness of certain reform proposals because they disagree in principle with the tax mix that would result. Some provinces have felt that they might suffer more significant negative impacts than other provinces as a result of certain reform proposals. For most provinces, personal and corporate income tax systems are linked directly to the federal tax system, and federal reforms automatically change provincial tax regimes and revenues. Under federal-provincial tax collection agreements, in particular, most provincial personal income taxes are calculated as a simple percentage of federal tax payable, so that a change in federal rules concerning deductions and exemptions automatically changes provincial rules. As well, most provincial systems for corporate income taxes are geared to the federal rules. Meanwhile, the retail sales tax has been the major tax field where provinces generally have had complete autonomy. Some of the federal proposals for a value-added tax could have seriously altered this final area of provincial independence.

Thus, quite apart from any tax reform intentions of their own, provincial governments have seen their tax systems significantly altered by the federal tax reform movement and must now re-examine their tax mix as it results from the federal reforms. In particular, the new federal intrusion into retail sales taxation, through the Goods and Services Tax (GST), will inevitably require a re-examination by each province of its own retail sales tax, including a decision whether to join the federal GST system and eliminate their current retail sales tax entirely.

In the context of these extensive federal reforms, this book is intended to provide for the non-specialist a fresh look at provincial tax reform options and opportunities. Part I begins with the basic principles of tax reform, considering alternative objectives and general options in tax design. An important subject for Canadian provinces is whether their tax systems

should be harmonized, with similar if not identical tax mixes and tax procedures. The case for harmonization is presented, as well as the case against. The federal-provincial tax collection agreements are discussed from this perspective.

Part II examines the current differences among provincial economic circumstances and tax structures. In view of significant differences in economic circumstances, some provinces may place a greater emphasis on the objective of economic growth, or a greater emphasis on equity, than would other provinces. In fact, substantial differences do currently exist in regard to tax mix, and these indicate the large scope for provincial tax reform that can be achieved simply by changing the relative weight that provinces place on alternative types of taxes. In addition to a general analysis of these, separate chapters are devoted to each of the personal income tax, the corporate income tax, sales taxes, and factor specific taxes. Certain factor specific taxes could play a greater role in provincial systems, thereby providing wider scope for independent initiatives. Equalization payments, as a tax-related transfer, are also discussed briefly.

Against this background, Part III deals with the process and implications of federal tax reform, from the 1987 proposals to the GST draft legislation. The book outlines the potential impact of the federal reforms on the provinces and suggests alternative provincial responses. In particular, it suggests an agenda for federal-provincial negotiations in regard to the GST, which balances the search for constructive and competitive independence, on the one hand, with scope for recognition of provincial differences, against the need to avoid a confusing and perhaps destructive "tax jungle", on the other hand.

The frequency of recent tax reform measures means that certain program descriptions and statistics may become outdated rather quickly. Nevertheless the basic issues remain, and the value of this book as an expository guide for provincial public servants and interested observers should continue well beyond the current reform process.

Rod Dobell, President May 1990

Avant-propos

Le Livre blanc de 1987 sur la réforme fiscale indiquait l'intention du gouvernement du Canada de procéder à des changements radicaux en matière de taxe de vente personnelle, corporative et fédérale. Les propositions formulées par la suite ont été fréquemment modifiées, pour répondre aux critiques de toutes sortes qu'elles avaient suscitées. Les gouvernements provinciaux se sont trouvés pris dans ce débat sur la réforme, et ce pour un certain nombre de raisons. Quelques provinces ont mis en doute la pertinence de certaines propositions de réforme, parce qu'elles n'approuvaient pas, en principe, la structure de la combinaison fiscale qui devait en résulter. Il y a des provinces qui ont pensé qu'elles risquaient de subir des effets négatifs plus importants que d'autres provinces, du fait de propositions de réforme particulières. Pour la plupart des provinces, le système d'impôt sur le revenu personnel et corporatif est directement lié au système d'impôt fédéral, et toute réforme fédérale affecte automatiquement les régimes et les revenus fiscaux provinciaux. En effet, conformément aux accords fédéraux-provinciaux sur la perception des impôts, dans la plupart des provinces l'impôt sur le revenu personnel provincial est calculé comme un simple pourcentage de l'impôt fédéral dû, si bien que toute modification aux règlements fédéraux relativement aux déductions et aux exemptions entraîne des répercussions au niveau des règlements provinciaux. En outre, la plupart des systèmes provinciaux relatifs aux impôts sur le revenu des corporations sont tributaires des règlements fédéraux. Par ailleurs, la taxe de ventes au détail est le principal domaine fiscal où les provinces, en général, ont pu jouir jusqu'ici d'une autonomie totale. Certaines des propositions fédérales en faveur d'une taxe sur la valeur ajoutée pourraient sérieusement réduire ce dernier domaine d'indépendance provinciale.

C'est pourquoi, indépendamment de toute intention de réforme fiscale qu'ils pourraient avoir, les gouvernements provinciaux ont vu leurs systèmes fiscaux grandement modifiés par le mouvement de réforme fiscale fédérale, et ils doivent maintenant réexaminer ce qu'il adviendrait de leur combinaison fiscale après les réformes fédérales. En particulier, la nouvelle intrusion du fédéral dans le domaine de la taxe de vente au détail, par le biais de la Taxe sur les produits et services (TPS), obligera inévitablement les provinces à réexaminer

leur propre taxe de vente au détail; elles devront notamment décider si oui ou non elles veulent se joindre au système fédéral de la TPS et éliminer complètement leur taxe de vente actuelle.

C'est dans ce contexte de réforme fédérale de grande envergure que les auteurs de ce livre se placent pour offrir au non-spécialiste des vues neuves sur les options et les possibilités que présente la réforme fiscale. La première partie de l'ouvrage est consacrée à l'étude des principes de base de la réforme fiscale; les autres objectifs et options qui peuvent être pris en considération, dans la mise au point d'un système fiscal, y sont également examinés. Par exemple, une question importante pour les provinces canadiennes est de décider s'il y a lieu d'harmoniser leurs systèmes fiscaux pour que les combinaisons et les procédures fiscales soient similaires, voire identiques, d'une province à l'autre. Les auteurs examinent tour à tour les arguments en faveur de cette harmonisation et ceux qui vont à son encontre. C'est selon cette perspective que les accords de perception des impôts entre le fédéral et les diverses provinces sont discutés.

Dans la deuxième partie, les auteurs traitent des différences que l'on rencontre d'une province à l'autre sur le plan de l'économie et des structures fiscales. Étant donné les écarts considérables que l'on observe entre les diverses économies, certaines provinces peuvent attacher plus d'importance que d'autres aux questions d'économie ou d'équité. En fait, il existe de réelles différences quant à la structure de la combinaison fiscale, et cela donne une indication de l'ampleur de la réforme fiscale qui pourrait se faire, simplement par une modification de l'importance relative que les provinces attachent aux diverses catégories de taxes de substitution. Outre l'analyse générale de tous ces aspects, la deuxième partie comprend des chapitres séparés qui sont consacrés à chacune des questions suivantes : l'impôt sur le revenu personnel, l'impôt sur le revenu corporatif, les taxes de vente et les taxes particulières à certains domaines d'activité. Certaines taxes de cette dernière catégorie pourraient jouer un plus grand rôle dans la fiscalité provinciale, permettant ainsi d'élargir le champ des initiatives indépendantes. Les paiements de péréquation, en leur qualité de transferts rattachés au système d'imposition, sont également brièvement discutés.

C'est en tenant compte de toutes ces données que, dans la troisième partie, les auteurs analysent le processus et les implications de la réforme fiscale fédérale, depuis les propositions de 1987 jusqu'au projet de loi sur la TPS. Ils brossent un tableau des répercussions que cette réforme pourrait entrainer au niveau provincial et ils suggèrent des solutions de rechange que les provinces pourraient envisager. En particulier, ils proposent, pour le fédéral et les provinces, un calendrier de négociations sur la TPS qui permettrait de trouver un équilibre entre, d'une part, la recherche d'une indépendance constructive et concurrentielle, dans le respect des différences provinciales et, d'autre part, la nécessité d'éviter un imbroglio fiscal qui ne pourrait qu'entrainer la confusion et peut-être des effets destructeurs.

La fréquence des réformes fiscales récentes condamne certaines descriptions de programmes et certaines statistiques à devenir rapidement dépassées. Il n'en va pas de même, toutefois, pour les problèmes de base qui sont, eux, appelés à persister, et la valeur de ce livre est justement de les mettre en lumière. Aussi devrait-il conserver son utilité, pour les fonctionnaires et pour tous ceux qui s'intéressent à ces questions, bien au-delà de l'actuel processus de réforme.

Rod Dobell, Président — Mai 1990

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As always, the analysis and conclusions presented here are those of the authors and do not necessarily reflect the views of the governments for whom our research has been conducted, or of the referees or reviewers.

Chapter I

Overview

1. Introduction

Our purpose in this book is to evaluate the tax reform options that currently face the Canadian provinces. Tax reform objectives include equity, efficiency, simplicity, and economic growth. From the perspective of these objectives, the reform process faces important general options concerning the choice of tax bases; the relative weight given to direct taxes and to indirect taxes; the use of certain exemptions and exclusions; and the choice of rate schedule. A major theme in this book is that significant differences exist among provincial economies and among provincial tax structures. It is unlikely, therefore, that tax reform preferences will be similar; rather, each province will develop its own reform agenda based on its unique economic circumstances, political value judgements, and historical tax experiences. To assist in understanding this process, we examine each type of tax separately: the personal income tax (PIT); the corporate income tax (CIT); the retail sales tax (RST); and factor specific taxes like payroll, capital, resource, and property taxes.

Canadian provinces today find themselves being affected by the federal government's tax reform program, and also that of the United States. Most provinces have signed tax collection agreements with the federal government under which the latter determines and administers the tax rules for the provinces' PIT and CIT. For these provinces, federal reforms may automatically alter the rates and structures of these provincial taxes. Of even greater political significance, Stage II of these reforms will replace the traditional federal manufacturers' sales tax (MST) with a type of value-added tax (VAT). A VAT will be a new tax for Canadians, raising a host of administrative and compliance issues. The particular form chosen by the federal government is referred to as a goods and services tax (GST). As an indirect tax, it could be integrated with existing provincial retail sales taxes. For provinces, a question of central concern over the coming years will be whether to eliminate retail sales taxes and enter a new tax sharing agreement.

Throughout this book, we point to the interactions between the tax system in each province and the tax systems of the other jurisdictions. Within Canada, each province is a relatively small open economy, and in each case, the export and import of goods and services form an essential component of economic activity. It is also true that both capital and labour can flow relatively freely across provincial borders and that provincial tax structures can alter these flows of goods, services, capital and labour. Consequently, in evaluating reform options, the impact of alternative taxes on these flows must be a central concern.

What makes this examination particularly complex is that the impact of one province's tax system on flows of goods, services, capital, and labour is affected by the tax systems of other jurisdictions. The differentials between the effective tax rates in the various jurisdictions are important determinants of these flows. This means that tax reforms at the federal and provincial level, as well as tax reforms in the United States, will directly impact each province and will affect the reform options to be considered. It is against this background that we consider the constitutional and practical limitations and opportunities for provincial tax reform.

2. Summary

Part I discusses the principles of tax reform. Within this subject, Chapter II examines the objectives of taxation focusing on equity, efficiency, simplicity, and economic growth. Equity involves a comparison of how a specific tax affects the well-being of one individual *versus* another. Conceptual problems include the definition of ability to pay and the choice of the appropriate tax bases and the appropriate degree of progressivity. Taxes can be shifted forward to the consumers of the item being taxed, and/or shifted backward to the suppliers of inputs used in producing the item being taxed. Hence in order to assess the impact of taxes on equity, one must look at the effective as opposed to the legal incidence of alternative types of taxes. Unfortunately, the determination of tax incidence is unclear for most taxes. And so considerable uncertainty exists concerning the true impact of taxes on equity.

Chapter II also discusses efficiency costs of taxation associated with the misallocation of resources as a result of the implementation of various taxes. It appears the cost of these distortions may be larger than previously believed. Many of today's reform advocates see the minimization of distortions and the simplification of rates and regulations not only as a means of improving efficiency but also as a way of stimulating growth. Detailed government manipulation of tax provisions is perceived as having a pervasive influence on the behaviour of private decision makers, who respond to tax provisions rather than market forces. The broadening of tax bases can increase revenue, and so can permit the reduction of statutory rates. Chapter II reviews this tax reform literature, focusing on the relationships between various types of taxes and the economy's aggregate levels of saving, investment, and labour supply. It is argued by some that dynamic efficiency over time requires tax incentives to alter free market decisions in regard to saving and investment. In this context, questions of importance include the influence of the tax system on the creation of new small businesses, and the ability of the tax system to modify the severity of recessions and inflationary expansions.

Chapter III considers the tax structure as a whole, and presents general options for broad design issues. Any type of asset or transaction can be chosen as a tax base. There are markets

for goods and services as well as markets for capital and labour. In each of these markets, one can distinguish between the operations of buyers and sellers, as well as households and firms. Taxes can be levied on these transactions both directly and indirectly, and can be applied on a broad base or aimed more precisely towards specific industries, economic agents, or income groups. Each of these options has economic consequences that can be evaluated against the taxation objectives described in Chapter II.

In fact, each Canadian province has relied on a mixture of the various kinds of taxes. The ability to pay – a central criterion in taxation – cannot be adequately measured by one single indicator or type of tax base. The benefits received from government expenditures depend on a number of circumstances which have to be dealt with explicitly if taxation is to be related to benefits. Furthermore, different types of taxes may create different types of inequities and distortions. Reliance on a single kind of tax could require such high tax rates that the consequent inequities and distortions could become unacceptably large. Compliance problems would also be exacerbated with the high rates of a single tax, as a strong incentive would exist to arrange one's economic activities to avoid the taxes. To raise revenue from a mixture of taxes may limit the particular inequities and distortions caused by each tax. In view of the need for a mixture of taxes, provincial tax reform must consider how best to combine the alternative taxes. Chapter III examines these broad design issues.

Chapter IV emphasizes that Canadian provinces have experienced widely differing economic circumstances, and that important differences persist today. Tax reform seeks to achieve several objectives, and the relative weight attached to each objective may be expected to vary among provinces. In recent years, some provinces have witnessed an increasing public concern about efficiency and growth. A number of developments have stimulated this concern. Newly industrialized countries are challenging the international competitiveness of certain traditional economic activities, not only in manufactured goods but also in natural resource products. Since the mid-1970s, a slowdown has occurred in productivity and wage increases in many provinces. Of most political significance perhaps, unemployment rates have risen sharply in many provinces, and they have stayed at unacceptably high levels. A new spectre of long-term unemployment threatens a major portion of some provinces' labour force. Young people in particular have faced unemployment difficulties in provinces where opportunities seem to have shrunk.

Chapter IV also considers the scope for provincial tax reform within the practical and constitutional constraints on tax diversity among Canadian provinces. This chapter discusses the rationale for harmonization of taxes among provinces. In presenting a rationale for a particular division of tax powers, authors usually build their argument around the need to reserve particular types of taxes for the federal government. The argument is often two-pronged, emphasizing issues of equity and also issues of efficiency. From the perspective of equity, some authors believe that taxes should affect citizens living in different geographical areas in similar ways and to a similar degree. For tax purposes it should not matter to a citizen where he or she lives within the federation, and so it should be a matter for the federal government to decide upon the appropriate degree of income redistribution. From the perspective of equity, taxes that can be shifted backward or forward should be reserved for the federal government. If this were not done, then a province could shift the burden of public expenditures from its own citizens to the residents of some other geographical area within the same nation. According to this view, provinces should levy taxes that are borne as completely

as possible by the residents of the taxing jurisdiction. In this way, the residents of each province pay for the public services that they receive.

A number of efficiency issues support this division of tax powers. For the maximization of aggregate national income, it is necessary that factors of production be located geographically on the basis of efficiency criteria rather than tax considerations. If the provincial governments were to impose different tax structures, then factors of production would include tax considerations in their decisions about where to locate. Provincial governments could consciously choose a tax structure so as to attract people and investments that it deemed desirable. The resultant competition among provinces could intensify the distortionary effects caused by different tax structures.

Some authors also emphasize that responsibility for stabilizing the economy should also rest with the federal government. Some view recession and inflation as national issues, requiring the judgement and action of the federal government. They believe that only the federal government is able to coordinate tax and expenditure changes so as to attain full employment with minimal inflation.

Chapter IV also examines the opposing rationale which favours tax differentials among governments in a federation. In particular, the preferences of residents may differ so significantly among jurisdictions that uniformity is simply not feasible. Such differences may even extend to preferences for different types of taxes and different degrees of progressivity. Some commentators argue that stabilization needs also differ significantly among geographical regions and so a uniform national fiscal policy is not desirable. "Failures" in the private marketplace may be more severe in some regions than in others – or they may be of a different nature. Furthermore, it may be argued that flows of labour and investment will tend to counteract any inefficiencies caused by tax differentials. Finally, in order to obtain similar after-tax income distributions it may be necessary to apply different degrees of progressivity among jurisdictions.

To a major extent, these arguments rest on the view that geographical units within the federation are not in fact similar. The nation is not homogeneous with regard to preferences or economic circumstances. Consequently, citizens in the various jurisdictions should expect to receive different tax treatment. One's support for either of these perspectives will rest upon one's perception of the purpose and nature of "nationhood." While we might automatically expect that individual preferences would vary among geographical regions, the real issue is the extent of these differences. Here we enter the realm of political judgement.

This chapter also considers the degree to which the Federal-Provincial Tax Collection Agreements limit the scope for provincial reform. In view of these constraints, an initial step in the reform process may be to modify these agreements, and some possible modifications are presented.

Public concerns about the increasing international competition, the slowdown in productivity and wage increases, and the persistence of high unemployment rates have led many to advocate a shift in tax objectives towards more emphasis on efficiency and growth. A widespread feeling has developed in many provinces that the equity objectives of income redistribution may have to be sacrificed somewhat in order to achieve greater efficiency and

growth. Yet this economic picture varies significantly among provinces, and consequently, the optimal reform agenda for each province may be unique.

While Part I discusses the principles of tax reform in general, we turn in Part II to the current tax structures of Canadian provinces. Because of differences in economic circumstances, the capacity to raise revenue varies significantly among provinces. For any particular tax and rate structure, the provincial revenue as a percentage of the tax base varies considerably. Chapter V examines this subject, presenting estimates of taxable capacity for each province. This chapter also presents historical data concerning the share of total revenue that each province has derived from each type of tax. What is most striking is the extent of the differences in tax mix among provinces. For example, the share of total revenue obtained from the PIT has varied from a low of 4.6 per cent in Prince Edward Island in 1970-1971 to a high of 27.0 per cent in Quebec in 1985-1986. The share of total revenue obtained from the RST varied in 1985-1986 from a low of 0.7 per cent in Alberta to a high of 19.3 per cent in Ontario. These findings emphasize the uniqueness of each province's existing tax structure, and hence, the uniqueness of each province's reform agenda.

Chapters VI, VII, VIII, and IX examine specific taxes and reform options for each of the personal income tax, the corporate income tax, the retail sales tax, and factor specific taxes.

Given the overwhelming importance of the PIT, both as a revenue source and as an influence on private sector economic decisions, Chapter VI looks closely at the incidence and potential shifting of this tax in order to reveal its impact on employment, investment, and growth. In addition, the role of personal tax credits for equity purposes is explicitly addressed. This equity consideration is particularly important to offset the regressive effect of reliance on sales taxes, and to target relief to specific groups such as the senior citizens.

This chapter also outlines specific tax expenditures either in force, or proposed, in Quebec, Ontario, Saskatchewan, and Nova Scotia. These tax expenditures have been designed to encourage investment in the corporate sector by means of income tax credits to financial investors; that is, tax relief to purchasers of corporate shares. The intended economic effect is to increase the pool of funds that can be invested and to reduce the corporate cost of capital thereby stimulating real investment. The programs are: (a) The Stock Savings Plan in place in Quebec, Saskatchewan, Alberta and Nova Scotia; (b) The Employee Share Ownership Plan as proposed in Ontario; and (c) Venture Capital Programs in place in several provinces, including Nova Scotia. The focus of the discussion is to indicate how much scope is available to implement provincial economic growth objectives, within the context of the personal income tax.

Chapter VII begins with a brief overview of the corporate income tax in Canada as it presently exists. This is followed by a survey of the direction of corporation income tax reform in North America as enacted recently in the United States and by the federal government of Canada. A discussion of using the corporate income tax for policy objectives such as growth, employment and equity, is followed by a section that addresses possible provincial reforms in this regard. This section also discusses the possibility of increasing provincial revenue through changes in the corporate income tax or by levying a related provincial tax such as a corporate capital tax.

For Chapters VI and VII – and for many elements of the later discussion – another important set of issues concerns the relationship between the PIT and the CIT. The

corporation's shareholder can be seen as paying both a CIT and a PIT on each dollar of corporate profit. This double taxation has led to many proposals for integration of the two taxes. In Canada, the PIT provides for a dividend tax credit which acts to reduce double taxation and to integrate the PIT and the CIT. Additional questions are raised by the need to allocate capital costs over the life of particular assets. Inflation adds another dimension to these questions, complicating the appropriate time profile for taxation of investment income. Reform proposals have arisen with many of these issues.

Sales taxes are a significant source of tax revenue for provincial governments. Based on 1985-1988 budget estimates, sales taxes were the most important source of revenues (apart from federal transfers) in New Brunswick, Newfoundland, and Prince Edward Island. In all other provinces, except Alberta, sales taxes were the second most important source of revenue after the personal income tax. Because of its relative importance as a source of revenue and its potential impact, the retail sales tax merits special consideration. Chapter VIII examines provincial retail sales taxes in the context of the general principles of indirect taxation. The issues of particular interest are the relative importance of RST as a source of revenue, the rate level, and the choice of exemptions and exclusions from the base. Excise taxes are also discussed (for example, taxes on gasoline and motor fuels, tobacco, and alcoholic beverages).

An additional issue concerns the second phase of the federal tax reform initiated in the 1987 White Paper. The federal government has clearly indicated that the approach being considered revolves around the implementation of a multi-stage sales tax. The implementation of the GST will have significant implications for the provinces. The definition of a value-added tax base is essentially equivalent to that of the RST, so that the federal government can be seen as moving into a tax field previously occupied by the provinces. Also because current RST rates apply to the value of goods gross of the manufacturers' sales tax (MST), replacing the latter with a broader-ranging sales tax at a lower rate will immediately affect provincial sales tax revenues.

Although both the federal and provincial governments rely heavily on three basic forms of taxes (the personal income tax, the corporate income tax, the general sales taxes) to collect revenues, there are a number of alternative forms of taxation that deserve attention. Although of relatively minor revenue significance at the present time, these factor specific taxes will become more important for the provincial governments in the aftermath of federal tax reform. If the provinces opt for a joint federal-provincial sales tax, the provincial governments may feel the need to increase their reliance on these other forms of taxation for revenue and tax policy purposes. Chapter IX presents issues which relate to the implementation and the impact of factor specific taxes such as payroll taxes, capital taxes, resource taxes, and property taxes.

In some cases, these factor specific taxes may be seen as resting on the benefits principle, that residents who gain from a certain government expenditure or activity should pay in accordance with their individual benefits. The property tax and certain excise taxes are sometimes seen in this light. Of particular concern in federal-provincial fiscal relations are the provincial taxes that capture resource rents. Residents of a resource-poor province may feel that they should share in these resource rents. Consequently, the autonomy of a province in this tax field is sometimes subject to constraints in the interests of equity within the nation. Several alternative mechanisms are sometimes used to extract resource rents, including lease auctions, royalties, marketing boards, and public ownership.

The issue of interprovincial sharing of resource rents is intimately linked with the concept of equalization payments. Transfers from the federal government to those provinces with a lower-than-average tax capacity have long been a central feature of Canada's fiscal federalism. Chapter X summarizes the recent history of equalization payments, and it indicates how the current formula serves to redistribute income. Apart from the progressivity inherent in the tax system itself, the equalization payments offer a tax-related way of redistributing income to the residents of poorer provinces.

Part III deals with the process and implications of federal tax reform. Implementation of federal reform will impact each province's economy through changes in the federal tax burden on the residents and corporations of the province. The extent of this impact will vary among the provinces, raising the federal tax burden for some and lowering it for others. Furthermore, those provinces whose PIT and/or CIT are part of a federal tax collection agreement will automatically experience changes in their provincial tax rules, rates, and revenues. Federal transfer payments will also be altered. The federal reforms will affect the provinces indirectly through changes in factor and commodity prices. It is also important to recognize that the net impact of federal tax reform will, to a great extent, depend on how provinces react and adjust to the federal plan. As Chapter XI emphasizes, provincial tax reform proposals will have to be considered in the context of the federal reform process.

Of great significance over the coming years will be the possible elimination of provincial retail sales taxes, and the integration of provincial indirect taxation with the new proposed federal GST. Chapter XII considers the various issues that will be involved in federal-provincial negotiations over such integration, and it emphasizes the GST design features that will be of most concern to the provincial governments.

The final chapter, XIII, presents a summary of the volume. This chapter's perspective raises the question of the appropriate degree of coordination among provincial reform programs. To a considerable extent, the answer depends on one's opinion regarding political differences in the tax preferences of residents in the various provinces. The earlier chapters have provided evidence concerning historical tax diversity within Canada and concerning differences among provincial economies. To opt for a coordinated and consistent reform agenda among provinces would entail a radical departure from previous practices. Yet the reform process in any one jurisdiction affects the tax system of the others. In particular, the federal reform process will impact all the provinces. Consequently, the development of separate reform agendas must be undertaken with an awareness of the intentions of others, with an appreciation for the impact on others, and – at many points – with explicit cooperation and coordination.

PART I

PRINCIPLES OF TAX REFORM

Chapter II

The Objectives of Tax Reform

1. Introduction

It is generally agreed that there are three major criteria to be used in evaluating a particular tax or the tax system as a whole. These are equity, efficiency, and simplicity. These criteria, either individually or in combination, have often been the key themes motivating tax reform proposals. However, because of some basic incompatibilities among these criteria at the implementation level, tax design usually involves a number of trade-offs. Unfortunately, there is no clear consensus about the severity of these trade-offs or about the relative importance of each criterion. This is further complicated by the fact that governments often pursue additional objectives through the tax system. Aside from the revenue-generating capacity of taxes, governments are also concerned with the stabilization impact of taxes and their influence on the rates of saving, investment, and growth.

In this chapter we look at the issues associated with the more common objectives of taxation. It is important to note that the conclusions to be drawn from an assessment of the trade-offs, and the order of priority assigned to the objectives, will vary considerably depending on one's perspective. For instance, the notion of acceptable equity and efficiency gains from specific tax provisions, or tax designs, will be quite different from the viewpoint of a federal government looking at the national economy as a whole, as opposed to a provincial government whose interests lie within its borders. Furthermore, the approach to these problems will depend very much on whether the basis of evaluation is the individual resident or the region as a whole. As emphasized in our introductory overview, the ability of the provinces to achieve these various objectives is somewhat constrained by the fact that each is a small open economy within the Canadian federation. Flows of goods, services, labour, and capital can be impacted by changes in the tax system in such a way as to cancel or distort the intended effects of particular tax changes.

2. Equity

Equity involves a comparison of how a specific tax affects the well-being of one individual *versus* the well-being of another individual. There are two aspects of equity which relate to taxation. Horizontal equity goals are met when taxpayers with equal "ability to pay" bear the same tax burden. Vertical equity on the other hand concerns the relative tax treatment that should be given to taxpayers with different levels of "ability to pay."

The concept of horizontal equity implies the use of some universally accepted measure of "well-being" or "ability to pay" in order to make comparisons among taxpayers. It is usually assumed that comprehensive income, also described as Haig-Simons income, is adequate for this purpose. However, there are several conceptual problems to consider if comprehensive income is to be used as the sole indicator of equity.[1] First, the fact that leisure is not taxed could lead to inequities which are not recognized. For instance, two individuals with equivalent income and tax burdens could spend very different amounts of time earning this income. The individual who works less, perhaps by choice, has more leisure time at his or her disposal, and leisure can be considered a form of imputed income. Another problem arises from the fluctuations of income over time. A tax or a tax system is termed progressive if those with higher incomes pay a higher percentage of their income in taxes than do those with lower incomes. Under a progressive tax system, two individuals can have the same average level of income over their lifetime, but if the income of one fluctuates more than the other there may be a discrepancy in tax liability (for example, the individual whose income fluctuates more will end up paying more taxes). This problem can be handled either by allowing a system of income averaging for tax purposes or by using some notion of "permanent" income as the tax base. Again this involves a judgement concerning the appropriate indicator of ability to pay.

It has often been argued that people should be taxed on what they withdraw rather than on what they contribute to the economic system, and that consumption is a better indicator of "ability to pay" than is income. This notion has been analyzed by several economists in recent years and proposals have been made to implement a system of taxation based on lifetime consumption. The important point is that the choice of a particular indicator of ability to pay will dramatically affect one's perception of the tax system's horizontal equity. If lifetime income is used as a benchmark, then the annual income tax is horizontally inequitable because it treats individuals unequally if they have the same lifetime income, with different earnings or consumption profiles. If annual income is used as a benchmark, then a consumption tax may violate horizontal equity.[2]

On the other hand, vertical equity not only requires that a value judgement be made as to the appropriate indicator of "well-being," but also involves the subjective issue of how progressive the tax system should be. An important constraint, in this case, is the disincentive effect on work associated with a tax system that overly equalizes post-tax incomes. In view of these considerations, there inevitably is plenty of room to disagree about the optimal degree of progressivity of the tax system.

To evaluate the vertical equity of the tax system, it is necessary to measure its incidence to determine how the reduction in purchasing power is distributed among income groups. The legal incidence of taxes indicates who is legally liable to pay the various taxes. However, this does not necessarily correspond with the effective incidence, which indicates who actually bears the burden of taxes once all market adjustments have taken place. The difference between legal and effective incidence is directly related to the amount of tax shifting that has

taken place. For instance, corporate income tax might be collected directly from corporations but if the tax is passed on through higher prices for the corporation's products, then the effective burden of the tax is either partially or totally shifted forward to consumers. Conversely, if the tax results in lower wages for the corporation's employees, then the tax burden is shifted backwards onto labour. In the longrun, investment decisions may be impacted by corporate taxes. Aggregate investment may be reduced, and if certain sectors are taxed more than others, investment in the heavily taxed sectors might be reduced disproportionately. These investment impacts may result in longrun tax shifting, quite apart from shortrun decisions about prices and wages. The extent of tax shifting will depend on the elasticities of supply and demand involved.

There is little doubt that tax shifting does occur and that legal tax incidence is therefore a poor indicator of effective tax incidence. Unfortunately, there is no clear consensus as to the actual patterns of tax shifting. Tax incidence has been the subject of numerous studies over time. However, these studies must be evaluated with the clear understanding that the results are directly related to the use of certain underlying assumptions. These assumptions, in turn, depend on the analyst's perception of the size of the elasticities involved and of the significance of other economic elements such as factor mobility. Judgements about these are often based on relatively little empirical evidence. In addition, the results depend upon the choice of indicator used to calculate effective incidence.

The income concepts used in incidence studies vary considerably. Comprehensive income, which is commonly used, includes not only conventionally defined money income but also other elements not included in basic income data such as capital gains, imputed rent from owner-occupied housing, and retained earnings. These series must be constructed from aggregate estimates allocated by income range on the basis of specific assumptions as to their distribution. Further adjustments can be made to measure income in the absence of the public sector (by subtracting transfers) or in the presence of the public sector (by including transfers and the value of government services and subtracting taxes).

Each of these variations in the income concept substantially affects the estimates of income by income range used to calculate effective tax rates and this can affect the pattern of incidence which is obtained.[3] More important, it has also been shown that incidence calculations are very sensitive to the choice of underlying shifting assumptions. Consequently, one's perception of tax incidence must be based upon what is essentially an educated guess concerning the most realistic set of assumptions. The following is a brief description of the standard incidence assumptions associated with various taxes as reflected in the most recent literature. A more detailed discussion of the redistributive impact of particular taxes is found in later chapters.

- *Personal Income Tax (PIT)*

Usually it is assumed that the PIT is unshifted and that the burden is distributed according to tax payments.

- *Corporate Income Tax (CIT)*

The incidence of the CIT has probably been the subject of more controversy than any other tax. A full range of shifting assumptions have received support in various studies over time, from those that assume no shifting (the tax is entirely borne by shareholders) to those that assume the tax is entirely shifted either backward onto labour and/or forward onto consumers. A widely accepted view is that the CIT is borne almost entirely by capital owners in the economy as a whole. An important question is whether the economy is open, in the sense that investors can shift their investments to another jurisdiction in response to a CIT, and in the sense that prices are set in a world market. To the degree that the economy is open, in the longrun the movement of investments elsewhere and the inability to raise product prices may shift the CIT backward onto labour and onto immovable factors of production like land and natural resources.

- *Property Taxes*

Until recently, it was commonly accepted that property taxes were regressive taxes. The portion of the tax that falls on land was assumed to be borne by landowners, while the tax on structures was assumed to be entirely shifted onto the consumers of the services provided by the structures. This view of the property tax is now being challenged by a new view that sees the property tax as a tax on capital income which results in a reduction of the rate of return to capital.

- *Sales and Excise Taxes*

Sales taxes can be applied to a wide variety of tax bases. When a sales tax is applied to a narrow range of goods, such as alcohol, tobacco, or gasoline, then the sales tax is referred to as an excise tax. Taxes on consumption are generally assumed to be borne entirely by the user, and allocated on the basis of consumption of each good and service that is taxed. The value-added tax deserves special consideration because of the federal government's announced intention to impose a version of this, namely the proposed GST, and Chapter XII discusses this.

- *Payroll Taxes*

The standard incidence assumption for payroll taxes is that they are entirely borne by labour. In competitive labour markets, the employer is able to shift its portion of the tax by lowering the wage rate correspondingly.

A quite different perspective in regard to equity involves the relationship between a certain tax and the benefits derived from government expenditures that are funded by that tax. This perspective may rest on the "benefits" principle that the recipients of certain benefits should be the people who pay for those benefits. It may be argued that taxes should be levied in proportion to each person's and each corporation's benefits. Often payroll taxes are

advocated from this perspective, as a means of funding some social security programs like unemployment insurance, workers' compensation, and pensions. Similarly, excise taxes on gasoline may be seen as a user tax on those who benefit from the road system. This benefits approach to taxation may be seen as a way of achieving horizontal equity, but it cannot be so readily directed at the achievement of vertical equity. Many taxes cannot be levied in proportion to benefit or use, and at the same time be designed on a progressive rate structure.

3. Efficiency

In contrast to equity, which is largely a subjective concept, efficiency can involve a more precisely defined notion of economic theory. Theory explains how, in markets operating competitively and without distortions, resources will tend to be allocated to their most productive use. Generally, efficiency is discussed in a static sense, with the focus on the current allocation of resources and production. Nevertheless, the intertemporal allocation of resources and production is also a major concern. From this perspective, dynamic efficiency relates to the society's saving, investment, and growth. It is in this sphere of dynamic efficiency that some argue for certain tax exemptions, deductions, and rates that may stimulate saving, investment, and growth. Such tax designs may conflict with the objectives of equity and simplicity, and even with the objectives of static efficiency. In view of this, we discuss saving, investment, and growth in a separate section.

In a theoretically ideal economy, from the perspective of static efficiency, three conditions would be satisfied:

(a) Efficiency in exchange, whereby, given a certain distribution of income, no improvement in society's overall utility could be achieved through a different allocation of production. Each consumer purchases units of each product to the point where the ratios of the marginal utilities derived from the last units of each product are equal to the ratios of the product prices. Since all consumers face the same price ratios, the marginal utility ratios are the same for each consumer.

(b) Efficiency in production, whereby the reallocation of factors could not increase the value of total output since factor services will continue to be used up to the point where the value of the additional output produced by using an extra unit of factor equals the price of its service. At this point the price of factor services and hence the marginal product for any factor will be the same throughout the economy.

(c) Overall efficiency, whereby there would be no welfare gain from reducing the output of one good to increase that of another. This is because the price of goods reflects their true marginal social cost and because individuals will consume units of a particular good up to the point where the marginal benefit equals the price.

A tax that would not disturb the conditions described above is a lump-sum or a poll tax. Because such a tax does not distort relative prices, it would not affect the taxpayer's pattern of activity or consumption. This would also be true of a flat percentage tax on all goods and services including imputed services and the value of leisure, but the practical design of such a tax would be very difficult. Otherwise,

> the imposition of a tax on the market drives a wedge between the amount the demanders are willing to pay and the amount required to compensate suppliers to produce additional amounts. The value the economy places on having another unit produced exceeds the cost to society to produce it, but because of the tax no more will

> be produced. The result is that society's resources are not being used efficiently. In general, too little of the taxed commodity (or factor) will ultimately be produced and sold.[4]

Because taxes generally discriminate on the basis of the type of good that is produced or the type of input that is used rather than on the basis of who the final consumer is, the distortions occur much more often at the level of production efficiency and/or that of overall efficiency. However, efficiency in exchange will also be disturbed by unequal taxation of final goods and services. Furthermore, efficiency in exchange will be disturbed in the case of a tax on investment income since the after-tax rate of return will differ between individuals in accordance with their marginal tax rates.

Overall efficiency is disturbed by the tax system when differences in tax rates occur across goods and services by creating a wedge between their marginal cost and their price. As a result, the marginal benefits are not proportional to the marginal costs, and resources are likely to be misallocated. Variations in sales tax rates among commodities or in tax burdens (whether corporate, property or social security taxes) among industries, will be the source of such distortions.

As is the case with tax shifting, the distortionary impact of a tax will depend on the market circumstances.

> Generally speaking, the inefficiency associated with a tax will be greater as the reduction in market output induced by the tax distortion is greater. The more elastic are demand and supply, the greater the change in output will be and the more inefficient the tax. Therefore, from an efficiency point of view, it is best to impose taxes on markets that do not respond much to price changes.[5]

Each component of the current tax system imposes distortions of one sort or another. Some of the more important distortions often associated with major taxes are discussed below. In view of its significance in current reform discussions, the GST is dealt with separately in Chapter XII.

The Personal Income Tax (PIT)

(a) taxes capital income from different sources differently (for example, capital gains exemptions, dividend tax credit, non-taxation of imputed rents);

(b) distorts the labour market by driving a wedge between wages paid and wages received; the importance of this distortion increases as income rises due to the progressivity in the rates;

(c) distorts the savings and investment market by driving a wedge between the net return on savings and the price paid by borrowers; also by taxing savings, the PIT favours current rather than future consumption;

(d) favours activities yielding imputed (non-taxable) income.

The Corporate Income Tax (CIT)

(a) may distort the capital market by misallocating resources away from the corporate sector and into the unincorporated sector, and by reducing the net rate of return to capital hence reducing the overall amount of capital investment;

(b) may distort the allocation of resources within the corporate sector by taxing various industries at various rates due to special tax provisions (for example, depreciation allowances, investment tax credits) and differential rates (for example, manufacturing, small business);

(c) by taxing part of the return for risk-taking, the CIT may discriminate against entrepreneurship and innovation;

(d) by allowing firms to deduct the interest on debt but not the cost of equity finance the tax may influence the financial structure of firms.

The Retail Sales Tax (RST)

(a) the RST favours tax exempt purchases if it is not applied across the board to all goods and services;

(b) to the extent that the tax results in lower demand for the taxed items there will be a reallocation of resources;

(c) because the RST decreases the real wage rate, it may result in work disincentives.

(d) in practice, many business inputs and investment goods are taxed, resulting in tax cascading. Consequently, the final product may bear more RST than solely the application of RST to the final sale, and this total RST burden may vary significantly among products.

The Manufacturers' Sales Tax (MST)

(a) with its many exclusions and exemptions from the tax base the MST favours tax exempt purchases;

(b) the MST creates incentives to modify the production and distribution process in order to minimize value added up to the manufacturers level;

(c) the tax discriminates against domestic goods by taxing imports net of margins. The tax applies to the value of custom duty but net of certain margins, such as insurance and transportation, which are part of the taxable value of domestic goods.

(d) as with the RST, many business inputs and investment goods are taxed, resulting in tax cascading and variations in tax burden among products.

The Excise Tax

(a) discriminates against the use of the goods which are taxed. Excise taxes on products such as tobacco and alcohol may be justified as user fees because the consumption of these products is believed to generate costs for society as a whole, such as the loss of productivity and higher health care and crime prevention expenditures. These taxes are also viewed as good sources of revenue because the demand for the taxed items tends to be inelastic.

The Property Tax

(a) discourages the accumulation of property if the supply of the latter is elastic;

(b) creates incentives to reallocate property from high tax to low tax jurisdictions to the extent that tax differentials do not reflect differentials in levels of services received;

(c) creates distortions by taxing at different effective rates, different types of property (for example, residential, non-residential, single family dwellings, multi-family dwellings, etc.).

It is important to note that while we are able to analyze distortions imposed by each tax considered separately, nevertheless, it is by no means clear how these various distortions combine and offset each other in an overall tax mix. In a complex system, this uncertainty may be an important consideration, and people's opinions may well differ.

There has been increased interest, in recent years, in the distortions caused by tax measures and several studies have attempted to estimate the costs to society of tax-induced misallocation of resources. The terms of excess burden, or deadweight, are used in referring to such costs. These studies suggest that the resource allocation costs of distortions caused by the tax system may be much larger than has often been supposed in the past. For instance, indications are that the corporate income tax, as it currently stands, causes capital to be misallocated among industries. On the other hand, the personal income tax favours current consumption over saving and future consumption. The costs of these distortions appear to be much greater than those associated with the disincentive effects of taxes on labour supply.

St-Hilaire and Whalley (1982) report a number of estimates of inter-industry distortions of capital use ranging from an annual welfare cost of 26 to 58 per cent of tax collections, while labour supply distortions are in the range of 2 to 4 per cent.[6] The results for Canada correspond to estimates produced elsewhere. For instance, Jenkins (1972), has calculated that the distorting losses associated with capital income taxation range from 0.7 to 1.4 per cent of gross national product (GNP).[7] On the other hand, Campbell (1975) estimated a marginal deadweight loss of 25 cents per dollar of revenue in the case of sales and excise taxes (including both provincial and federal taxes).[8]

In their study of non-residential property taxes, Ballantine and Thirsk (1979) indicate that if a single municipality imposes a higher tax rate than other municipalities, this will not only result in the misallocation of capital but it will also cause an inefficiently high level of public expenditure. The authors calculate that for every dollar of extra revenue, between 35

and 55 cents would be spent inefficiently; that is, the value of services provided to residents would be less than the cost of provision of these services. They also conclude that an increase in the non-residential property tax rate would lead to a reduction of between 25 to 55 cents in real income in the economy for every dollar of additional revenue generated, depending on the size of the tax differential.[9] The tax can therefore be considered "extremely inefficient." These observations, along with indications that the overall tax system may be more redistributive than is generally believed, lend support to the view that "the removal of distortions should be given much higher priority in tax reform than appears to have been the case for the past 20 years."[10]

4. Simplicity

While equity and efficiency have long been considered important objectives to achieve in tax design, it is only in the past decade or so that simplicity has become an issue of equal concern. In fact, it can be said that the recent tax reform episode in the United States was motivated by the desire to simplify a tax system riddled with exemptions, deductions, loopholes and special concessions that alienated the majority of taxpayers. The need to simplify the tax system is also a concern in Canada although the situation here has not been perceived to be as serious. A related issue is the need for stability in regard to the tax system. Simplicity may be seen as minimizing the frequency of changes in tax provisions, so as to minimize transitional problems of interpretations and adjustments.

The current state of complexity of the tax system can be seen as the result of two factors. The first is inherent to the tax reform process itself.[11] Tax reform is not an even, continuous process. Attempts to evaluate and modify tax systems on a comprehensive or broad basis are, in general, few and far between. When they do occur they usually result in the implementation of a wide range of proposals following a series of compromises, adjustments and deletions to initial recommendations, which may or may not have been appropriate. What follows between reform episodes is what could be called the "band-aid" approach, whereby series after series of special provisions are implemented to (a) remedy specific problems which materialize after reform proposals are in effect; (b) bring relief to specific entities judged to be unduly affected by the tax system; or (c) promote specifically desired economic activities. The complexity of tax systems, to a great extent, stems from the noncompatibility of basic tax objectives. The band-aid approach, on the other hand, inevitably leads to a system of ever-increasing complexity which eventually calls for a thorough tidy-up operation.

The second factor contributing to the tax system's complexity is a consequence of the choice of tax base. The tax systems in both Canada and the United States are based on the notion of comprehensive income as a measure of ability to pay. Unfortunately, such a tax base is practically impossible to implement in its ideal form. Theoretically, all sources of revenue should be included in the tax base on an accrual basis and in real terms. Also, individual sources of income should be taxed only once. A large number of complexities found in the personal and corporate income tax system stem from attempts either to approximate this ideal tax base despite practical constraints or to minimize the related problem of tax avoidance.

The current concern over the complexity of the tax system is the result of an increased awareness of the direct and indirect costs of this complexity. Complexity is seen as "undermining general confidence in the fairness of the tax system, fuelling the growth in the

underground economy and reducing compliance."[12] Some of these costs are tangible while others are not. The more complex the system is, the more costly it is to administer and enforce. This, in turn, results in the need to increase statutory tax rates to collect the necessary revenues which compounds any negative impact of tax rates on incentives. On the other hand, from the taxpayers' point of view, tax compliance requires more time and resources, and this in itself is more than enough incentive to both avoid and evade taxes. These concerns over complexity explain the approach to tax reform adopted by the United States in 1986. The basic philosophy behind the 1986 tax bill was that by eliminating many of the exemptions and deductions that had accumulated, it would then be possible to reduce tax rates substantially while at the same time decrease compliance costs and improve the fairness of the tax system. It is not clear that these goals have been achieved.

The objective of simplicity also relates to the concept of political acceptability. Since most taxpayers have the right to vote, it is necessary that taxes be understood by the general public and be perceived by them as fair. Otherwise, those in political power who impose the taxes may be voted out of office. If a particular tax is designed with complex rules, then the residents may regard that tax as unfair because of its complexity. Some might argue, for example, that the federal government's proposed GST has encountered opposition for this reason. If the tax system as a whole involves many taxes, each with complicated rules, then residents may support the reduction of government taxes and expenditures because of this tax complexity, rather than because of an ideological preference for a smaller government. With the need for political acceptability, the choice of tax mix may be affected by the degree of simplicity with which alternative taxes can be designed.

5. Other Considerations

As mentioned above, the concept of efficiency is based on the premise that resources in competitive markets will be allocated to their most productive use. In this context, taxes are seen as introducing a distortion in the efficient operation of the market. Through their impact on the rates of return involved, taxes can affect the supply of labour, the rate of saving, and the rate of investment. Because taxes affect the supply of labour and capital, which are major determinants of GNP growth, governments often attempt to design taxes that will foster the accumulation of these factors of production. Another target of tax policy is the rate of technical progress, that is, the productivity with which resources are used. By providing R&D tax incentives, preferential tax treatment of small businesses, and investment tax credits, governments hope to foster innovation and entrepreneurship in such a way as to increase factor productivity and economic growth. From a policy point of view, the dilemma is whether the economic benefits achieved by using the tax system to influence the workings of economic activity will outweigh the costs associated with the potential misallocation of resources. The following subsections discuss these issues.

(a) The Impact of Taxes on Labour Supply

Taxes levied against labour income may alter each individual's choice of leisure *versus* work. Higher income tax rates reduce the material reward for work. Here it is necessary to distinguish between average and marginal tax rates. Higher marginal rates for a given

average rate will reduce hours of work. Nevertheless, in theory, higher average rates for a given marginal rate may increase hours of work. In general, many people expect that higher income tax rates will reduce the number of hours worked – people will opt for more leisure and less work. This impact of tax rates on labour supply may not be the same for other types of taxes. It is important to consider the differences between income and sales taxes in this regard. This leads to several important implications for the design of a tax structure.

First, in order to minimize this reduction in hours worked, a government may decide to limit its reliance on labour income taxes. A government may feel obliged to impose other types of taxes, in spite of their distortions, and it may rely on a mix of taxes. Second, a government may decide to limit its marginal tax rates for high-income people even if it might prefer greater tax progressivity for equity reasons. Third, a government may decide to tax different kinds of labour at different tax rates if it believes that the labour-leisure choice varies across occupations.

Recent years have seen an increased interest concerning the impact of income taxes on hours worked. Popularization of the "Laffer Curve" has been an element of this. Arthur Laffer has claimed that when income tax rates are raised, the government's total revenue may actually fall because of this impact. A relationship – the Laffer Curve – can be drawn between tax rates and total revenue. With income tax rates at zero, revenue will be zero. Similarly, with tax rates at 100 per cent, revenue will be zero. Hence, as tax rates rise from zero to 100 per cent, revenues first rise, then reach a maximum, and finally fall towards zero. In the early 1980s, Laffer suggested that income tax rates in the United States were so high that a reduction in rates would actually increase government revenue. Laffer's position was part of the "supply side economics" that underlay President Reagan's initial tax cuts in 1980-1982.

Closely related to this view is the concern about non-market activities. For many types of taxes, if tax rates reach a certain level then people will devise schemes to exchange their labour and products without any formal records that would attract tax. Some observers believe that tax rates have been so high that this non-market sector has grown rapidly in size. For example, Ethier (1985) has estimated that the "underground" sector in Canada generated output equal to six per cent of measured GNP in 1981. Paquet (1989) has presented substantially higher estimates of Canada's underground economy.[13] Moreover, while many people may not try to evade taxes they may spend a great deal of effort discovering and utilizing legal tax loopholes. Even though these activities are legal, they involve a waste of society's resources.[14]

Hausman (1985) provides an extensive discussion of the results of a large number of empirical studies on the effects of taxes on labour supply. An important conclusion is that there are substantial differences in the labour supply behaviour of different categories of workers. For example, while tax cuts seem to have a relatively insignificant impact on the labour supply of males, the labour supply of wives is very responsive to tax cuts.[15] As Rae (1984) points out, this information could affect a government's choice of tax structure: "this would imply a policy of lower tax rates for secondary workers in the family and higher tax rates for primary workers."[16] Rae notes the advantages of current Canadian tax provisions in this regard. In Canada, members of a family can file separate tax returns whereas in the United States "joint filing effectively imposes higher tax rates on secondary workers."[17] Prior to Canada's 1988 income tax reform, the income of the lower-income spouse was effectively taxed at the marginal rate of the higher-income spouse up to the income level at which the

marital exemption was exhausted. This work disincentive was eliminated with the 1988 shift to the tax credit system.

Overall, the question of the impact of taxes on labour supply is still unresolved. However, indications are that the effect is probably much less than had originally been assumed. A Canadian study by Hartle (1983) found that the elimination of the entire personal income tax on wages would have very little effect on the supply side of labour.[18] The issue of non-market activities is probably more important, particularly for provinces where primary production (fishing, farming, logging) is relatively substantial.

(b) The Impact of Taxes on Savings and Investment

It is generally agreed that the main influence of the tax system on economic growth occurs through its effect on saving and capital formation. A larger capital stock, combined with labour, renders the latter more productive. The capital formation, which raises labour productivity, results from investment – an activity that is determined by the workings of the capital market. Taxation is seen by some as having a significant influence on economic growth through its effect on capital accumulation, either in reducing the demand for investments or reducing the supply of savings used to finance investment by taxing capital income (interest, dividends, and capital gains) and by reducing the marginal rate of return to corporations from investing (corporate income tax).

The impact of tax policy on private sector savings is important because it affects the division of resource use between current and future consumption (saving implies a delay in present consumption to provide for future consumption) and between current consumption and capital formation. Households contribute approximately 40 per cent of total private savings in Canada. Nearly two-thirds of corporate savings consist of capital consumption allowances. Here it is important to distinguish between net and gross savings. As capital goods deteriorate over time, some amount of savings and investment will be necessary solely to maintain the existing level of the society's aggregate capital.

The tax system affects household savings in two ways. The progressive income tax is seen as a deterrent to savings because household saving, as a percentage of income, rises with income. However, this impact is much less than one might assume. The reason is that the difference in impact on the consumption-saving decision of a low-income household and a high-income household depends not on the difference in the average rates of savings but on the difference in their marginal rates of savings, which does not vary as much as the former with changes in income. The implication of this observation is that feasible changes in the tax structure are unlikely to have a major effect on the savings rate of the economy. However, the savings rate may be altered by taxation, not only because the income of the taxpayer is reduced, but also because the income tax reduces the net rate of return on saving by taxing interest income. The issue here is to what extent the savings rate is influenced by changes in the rate of interest. As we shall see, this question remains very much open to debate.

For the most part, corporate savings are in the form of capital consumption allowances. While these allowances are designed to reflect the deterioration in capital goods over time, nevertheless, in practice they may differ considerably from true economic depreciation. These charges are not affected by the profits tax (although their timing may be) because the profits

tax is imposed after the deduction of the capital consumption allowances. The remaining portion of corporate savings are more likely to be affected by taxes. To the extent that profit taxes are not shifted, after-tax profits will be reduced by the tax and this may reduce corporate savings by lowering retained earnings.

Taxes not only affect the saving activity but also the investment activity necessary for capital formation. A combination of tax effects will affect investment behaviour. Three relationships can be identified: (a) the profits tax reduces the expected net rate of return on investment; (b) by affecting the level of corporate sales, the tax system influences the need for increased capacity and the investment behaviour of the firm; and (c) by affecting the form of depreciation reserves or retained earnings, the profits tax influences the availability of internal funds which is a variable in the investment decision.[19] In this context investment may be stimulated by reducing the rate of tax, speeding up the time profile of capital consumption allowances, or granting investment credits.

A number of tax measures can be implemented to reduce the taxation of interest income. These can perhaps best be understood as following either of two approaches. First, taxes can be raised on those types of incomes that do not include a return for saving and investing, and specific exemptions and deductions can be allowed for income that is related to saving and investment. This type of reform would shift the taxation of income to a labour-income base. This approach is reflected in the taxation of corporate dividends at a lower rate than other income; the exemption of capital gains from taxation; the delayed taxation of some types of interest income until that income is actually realized; the pre-reform Canadian $1,000 interest-income deduction; and the special tax treatment of owner-occupied housing where the imputed rent and the capital gains on such property are both exempt from taxation.

The second approach is to permit deductions of various kinds of saving in the calculation of taxable income. This type of reform would shift the focus of personal taxation from an income base to a consumption (expenditures) base. If saving is deducted from income in calculating tax payable, then only actual expenditures are taxed. Current tax treatment of Registered Retirement Savings Plans (RRSPs); Registered Pension Plans (RPPs); and the Canada and Quebec Pension Plans (CPP and QPP) follow this approach.

Many tax measures introduced in Canada over the past decade have followed these approaches with the hope that they might increase saving and investment. Of course, there are other reasons for some of these tax provisions in addition to their possible impact on saving and investment. These tax measures have resulted in wide variations in effective tax rates on capital among sectors and activities. Yet, at this point in time, the net impact of such reforms on saving remains unclear. After reviewing a number of studies designed to measure the responsiveness of savings to various tax incentives, Professors Boadway and Bruce (1985) concluded:

> [at] the moment, "not proven" is the best verdict one can base on the empirical evidence of the effects of tax incentives on saving, although it remains plausible that they have elevated Canadian savings rates relative to U.S. rates.[20]

There are many reasons why the tax incentives may not have the desired effect. Many theoretical studies note that if individuals save to achieve a particular level of retirement income, then any increase in after-tax rates of return would mean they could actually lower their savings rate and still reach their targeted level. With regard to the incentives actually introduced in Canada, Jump and Wilson (1982) argue that many of them – the pre-reform

$1,000 interest-income deduction, RRSPs and RHOSP – were essentially lump-sum transfers to households which had no effect on marginal savings.[21] Their effect on aggregate savings, moreover, depends on how the government responds to the loss of tax revenue. Either the government budget deficit is permitted to rise, or extra revenue is collected by raising the general level of taxes. A higher deficit means that the government sector's dissaving is rising and thus offsetting the higher saving by the household sector. Higher taxes, on the other hand, while preventing a rise in government dissaving, reduce the ability of households to save.

Whether tax incentives have much of an impact on aggregate investment is also an unsettled question.[22] Early work by Hall and Jorgenson (1967) showed that investment tax incentives had very large effects on the investment expenditures of the U.S. manufacturing sector.[23] In Canada, studies by McFetridge and May (1976) and Harman and Johnson (1978) confirmed that investment by the Canadian manufacturing sector was sensitive to changes in tax incentives.[24] However, it appears that the tax revenue forgone was almost equal to the extra investment generated.

In addition to examining the effects of taxes, economists have also been interested in the effects of overall government budget policy on savings and investment behaviour and on the welfare of current and future generations. The framework used in much of this research builds on the theory of economic growth developed by Solow (1956) and Uzawa (1961) with an emphasis on the steady state of the economy under different government policies.[25] The evidence indicates that, compared with equal-yield consumption taxes, income taxes depress saving, and hence (at least in a closed economy) investment, resulting in quite large longrun welfare losses. Investment and capital formation may also be depressed by the use of debt financing. A pay-go public pension system or one that is underfunded may have a similar impact: public pensions may reduce private saving while not comparably increasing public saving, and hence the capital stock may be reduced. While there is no agreement on the exact size of these effects, there is a consensus that the potential gains from reforming these aspects of government policy may be quite large.[26]

Overall, the impact of fiscal incentives on saving and investment are constrained by the relative openness of the Canadian economy. Because of the mobility of capital, the rate of return to savings in Canada has to be in line with that determined by the world market. It also means that the volume of domestic investment is not exclusively dependent on the level of domestic savings. The tax concessions designed to increase savings could mean less reliance on savings from foreign sources but not necessarily an increase in the total supply of savings available for investment in Canada. If foreign investors can deduct the taxes that they pay in Canada against taxes payable in their homeland, then their total tax burden is unchanged by the investment incentive measures, and Canadian tax concessions simply raise the foreign government's revenue by an equivalent amount. For example, under current tax provisions in the United States, some Canadian taxes can be deducted by investors in the United States when they calculate their tax payable in that country. If a Canadian government were to reduce these taxes, then U.S. investors would pay the same total tax bill, however a larger share would accrue to the U.S. government. Since such a substantial proportion of Canadian industry is owned by firms based in the United States, many people regard the Canadian corporate income tax from this perspective. Reduction of the federal or provincial corporate income taxes would, to some extent, be a transfer of tax revenue from the Canadian governments to the government in the United States. In fact, Deutsch and Jenkins (1982)

calculated that a decrease in the corporate income tax rate on Canada's manufacturing sector from 46 per cent to 40 per cent would result in a revenue loss of $72 million. Of this total, $56 million (or 78 per cent) "would end up in the coffers of the United States government in the form of additional taxes collected."[27] For these reasons, certain tax reforms that may be desirable as a way of increasing savings and investment in a closed economy, may not be desirable in a small open economy.

Finally, there are two additional types of tax policies that should be discussed in the context of the economic growth objective. Research and development (R&D) tax incentives aim to encourage firms to undertake this form of activity in the hope that it will lead to innovation and increased productivity. Evidence suggests that such measures have been somewhat successful but that other policy measures affecting the general economic environment probably play a greater role in encouraging R&D in Canada.[28] Furthermore, as Canada's experiment with the *Scientific Research Tax Credit* indicated, many people may attempt to qualify for such tax benefits even though their activities may involve little or no research and development.

Many reform advocates seek to encourage the development of new small business. Indeed, many people believe that new small business ventures provide society with special economic benefits. Evidence exists that job creation occurs to a greater degree in new small businesses rather than in the expansion of the older, larger firms in traditional industries. Indications are that innovation occurs to a greater degree in small businesses. It is often argued that shortcomings or "failures" in capital markets make it difficult for small businesses to acquire financing on the terms and conditions that would be socially optimal. There is some evidence to suggest that tax concessions to increase the availability of new small business capital and decrease its costs may be desirable.[29]

In conclusion, we must emphasize that the issue of the impact of taxes on economic growth is really a question of whether the benefits to be reaped from providing special tax measures to encourage savings and investment outweigh the costs from the misallocation of resources resulting from the interference in the capital market operations. It may be that minimizing the tax induced distortions is a preferable policy approach.

A major concern is that special tax measures inevitably result in a narrower tax base that compounds distortionary tax effects. This was one of the major issues raised in the U.S. Treasury I report.

> The lack of a comprehensive income tax base has two obvious and important adverse effects on the ability of the marketplace to allocate capital and labour to their most productive uses. First, the smaller the tax base, the higher tax rates must be to raise a given amount of revenue. High tax rates discourage saving and investment, stifle work effort, retard invention and innovation, encourage unproductive investment in tax shelters, and needlessly reduce the nation's standard of living and growth rate.
>
> Second, tax preferred activities are favoured relative to others, and tax law, rather than the market, becomes the primary force in determining how economic resources are used. Over the years, the tax system has come to exert a pervasive influence on the behavior of private decision-makers. The resulting tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production, and reduced consumer satisfaction.[30]

Furthermore, it is not clear whether the special tax incentives introduced in the tax system have had the desired effects. Certainly, the view underlying the U.S. tax reform is that they have not, and there is even concern that the net impact might in fact have been negative. Studies in Canada indicate that provisions such as the accelerated capital consumption allowances and the investment tax credit are largely responsible for the wide dispersion in effective marginal corporate tax rates across assets, forms of finance and industries.[31] On the other hand, it has also been demonstrated that investment is sensitive to tax changes, although it appears the revenue loss due to the measures may be of the same order of magnitude as the amount of investment induced.[32] Numerous studies have also analyzed the effect of the corporate tax on savings and risk-taking, but the evidence so far is inconclusive.

In view of these considerations, it is likely that the issue of economic growth in the context of tax reform will shift from a concern about ways to encourage economic growth through special tax incentives to a desire to design tax systems that interfere as little as possible with the free market's determination of economic growth. Certainly a central concern underlying both the 1986 U.S. Tax Reform Act and the 1987 Canadian White Paper on Tax Reform was the implementation of the efficiency and simplicity objectives that minimize distortions instead of creating new ones.

5. The Tax Structure as a Mechanism for Economic Stabilization

The tax system has long been viewed as an important tool of stabilization policy. Changes in tax revenues affect the disposable income in the hands of consumers and corporations. To the degree that aggregate demand is a function of disposable income, changes in tax revenues can affect an economy's income and employment. In particular, economic recession may be moderated if tax revenues are decreased; and the inflation of full employment may be restrained if tax revenues are increased.

Conscious manipulation of tax rates over the course of economic cycles may offer a means of fostering steady growth without extreme unemployment on the one hand, or inflation on the other. Since the 1930s, "Keynesian economics" has been optimistic that governments would be able to alter their tax revenues in this manner.

The progressive personal income tax has been regarded as particularly important because of its tendency to act as an "automatic stabilizer." Recession would lower personal incomes; people would fall into lower tax brackets; and tax revenue would automatically fall. Inflation would increase personal incomes; people would rise into higher tax brackets; and the tax revenue would automatically increase. A great advantage of the progressive personal income tax was that this automatic impact precluded the need for a conscious government policy change. Any lags or errors in forecasting and decision-making would be avoided. The change in tax revenue would automatically be commensurate with the intensity of the business cycle. Other income-sensitive taxes may also contribute to this "built-in stability." In this regard, the contribution of each tax depends not only on its progressivity with respect to its base, but also on the sensitivity of the base to changes in GNP.

In recent years there has been some debate about whether tax changes can affect aggregate economic activity.[33] However, there remains considerable faith that the tax structure may in fact be used by government as one means of stabilizing economic activity,

and there is some confidence that provincial governments have an important role to play in stabilization policy.[34]

6. Trade-offs and Choices Among the Objectives

In this chapter we have reviewed some of the basic objectives of tax design and tax reform. Even a brief description of these basic objectives makes patently obvious the fact that these are to a great extent incompatible, and that to subscribe to any one or more of these objectives immediately involves trade-offs. For instance, enhancing the progressivity of the income tax may improve the vertical equity of the tax system, but the higher tax rates may exacerbate the distortionary effects of the tax. Furthermore, enhancing the progressivity of the income tax may also worsen horizontal equity if some sources of income are taxed more lightly than others. Special tax provisions to encourage R&D activities or entrepreneurship may be beneficial, but they also might create a more complex tax system and generate additional distortionary effects in the economy. The dilemma reflected in tax reform debates, in both Canada and the United States, is whether the tax system should be used as a policy tool to stimulate economic growth, or whether it should be designed to interfere as little as possible with market operations. On balance, the latter approach seems to prevail at this point in time.

The degree of objectivity in ranking the criteria related to tax design is restricted by the state of current economic analysis. Accurate measurements of the various trade-offs involved are simply not available. Consequently, the relative importance attached to various objectives at any point in time will involve a certain amount of subjective judgement on the part of governments. According to Sheppard (1986), to resolve these conflicts

> we must balance the relative importance of the criteria, making compromises or trade-offs among them. Each of us will have personal preferences about the proper ranking of the criteria. Even a royal commission cannot agree upon the most important criterion. The Belanger Commission [on taxation in Quebec] felt that adequacy was the "primary purpose of taxes." The highly influential Carter Commission gave "primacy of place" to equity. The Smith Committee [on taxation in Ontario] also felt that equity "rises above all the rest, both because a majority of the remaining characteristics flow from it and because it goes to the core of constitutional democracy." The Meade Committee [on direct taxation in the UK] declined to address the question considering it to be a matter for "the political process" to determine. The Asprey Committee felt that the three "dominant tests were equity, practicality and neutrality." Among contemporary policy analysts, neutrality is growing and equity is declining in importance. Our choice depends upon what we consider to be the most serious economic, social and political problems.[35]

This issue is further complicated by the fact that the assessment of the economic, social and political problems is likely to be quite different depending on the perspective adopted. The federal government can be expected to view these problems in a very different light than a provincial government. There is also no reason to believe that most provinces would agree on the choice of the most important objectives. For provinces concerned about relatively high unemployment rates and lower than average per capita income, it very much matters whether the federal government approaches tax reform with the view to improve the redistributive effects or with the view to remove the distortionary impact of the tax system. On the other hand, the residents of provinces such as Ontario are more likely to benefit from capital gains

exemptions, increased limits on deductible RRSP contributions, or the accelerated capital consumption allowances available to manufacturing industries. The point is that the national interest may not always coincide with regional interests. Furthermore, the revenue interests of a provincial government may not coincide with the personal financial interests of its residents. If a provincial tax base is tied to the federal base, then a new tax concession could reduce a certain province's revenue even though that province's residents may benefit disproportionately. For example, a federal capital gains tax exemption could reduce the Ontario government's revenue disproportionately, although Ontario residents could benefit disproportionately.

The federal government, having chosen a particular combination of taxation objectives, may find that the effects of the tax measures vary substantially among the provinces. From a provincial point of view, it is important to recognize that there is only limited room to maneuver in pursuing various tax objectives. Provisions in both the Canadian Constitution and the federal-provincial tax collection agreements restrict the provincial tools available to implement the taxation objectives discussed above.

The personal income tax is considered the most important tax as a collector of revenues, as an instrument of income redistribution, and as a relatively efficient tax. However, all provinces, except Quebec, collect the tax as a percentage of federal PIT paid. The provinces can set their own rates but must adopt the tax base and the rate structure established by the federal government. The only way a province can affect the progressivity of the PIT is through tax credits or surtaxes. Currently the provinces have no recourse to either simplify the tax or improve its efficiency. The case is similar for the corporate income tax. In this instance, a separate provincial rate is applied to the tax base determined by the federal government. Distortions associated with the definition and the allocation of the tax base are therefore beyond the province's control. The province does apply differential rates according to industry characteristics (for example, small businesses pay a lower rate). But for the main part, the provisions which create inter-industry distortions on the one hand, and stimulate particular types of economic activities on the other, are under federal jurisdiction.

In general, provincial governments have control over only a certain percentage of their revenue. The most important provincial taxes are the RST, the gasoline and motive fuel tax, and the real property tax. The RST is by far the most important among these, and it is an inexpensive revenue raiser. However, the RST is generally perceived as a regressive tax and traditionally has not been applied in a neutral fashion. There are a large number of exemptions that reduce the regressivity of the tax somewhat, but at substantial cost, in terms of tax revenue lost and reduced efficiency. Moreover, given the structure of this tax, it is difficult to ensure that only final purchases are taxed. Recent studies suggest that perhaps as much as 40 per cent of the RST applies to producer products or input purchases. On the other hand, gasoline taxes are also regressive in nature and distortionary in that they discriminate against a specific product. However, they can be considered a user fee directly related to highway usage. The issues concerning the property tax are not as clear. Depending on whether this tax is considered an excise or capital tax, the incidence effects are very different. The specific tax reform issues associated with particular taxes are discussed in later chapters. Chapter III reviews some of the basic options in tax design.

Notes

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10. St-Hilaire and Whalley, p. 64.

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31. See for example, M. Daly, J. Jung, P. Mercier, and T. Schweitzer, *A Comparison of Effective Marginal Tax Rates in Canadian Manufacturing*, Economic Council of Canada, Discussion Paper, No. 293 (Ottawa: Economic Council of Canada, 1985).

32. D.C. McFetridge and D.W. May, "The Effects of Capital Cost Allowance Measures on Capital Accumulation in the Canadian Manufacturing Sector," *Public Finance Quarterly* 4 (1976), pp. 307-322.

    F.A. Harman and J.A. Johnson, "An Examination of Government Tax Incentives in Canada," *Canadian Tax Journal* 26 (1978), pp. 691-704.

33. Reservations about the ability of governments to alter the level of aggregate economic activity arise for the following reason: government must finance its deficit by issuing bonds. Citizens may regard these bonds as simply a temporary delay in tax payments that they will have to meet sometime in the future. To the extent that household savings increase in anticipation of these tax liabilities, a reduction in taxes and an equivalent increase in bond financing will leave the aggregate level of economic activity unchanged. Of course, there are many other reasons for scepticism regarding a government's ability to stabilize the economy, including for example, difficulties in obtaining and analyzing appropriate information, and lags in the formulation and impact of fiscal policies.

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Chapter III

General Options in Tax Design

1. Introduction

This chapter will discuss the major strategies or options for implementing the objectives that were described in Chapter II. Tax systems at the Canadian federal and provincial levels have evolved into complex structures as a result of wide-ranging social, political, economic, and administrative considerations. An evaluation of these structures indicates that there are several important options in tax design, and that the implementation of these options has complex and significant economic implications. The choice of tax base is limited only by the types of transactions which occur throughout the economy. There are markets for goods and services as well as markets for capital and labour. In each of these markets we can distinguish between the operations of buyers and sellers, as well as households and firms. Taxes can be levied on these transactions both directly and indirectly, and can be applied on a broad base or aimed more precisely towards specific industries, economic agents, or income groups. Each of these options has economic consequences that can be evaluated against the taxation objectives discussed in Chapter II. The purpose of this chapter is to describe some of the general options available in tax design and to present some of the economic issues associated with the implementation of these options.

2. The Tax Base

Tax systems at both the national and sub-national levels include a number of different taxes that apply to a mixture of bases on either a general or selective basis. As demonstrated by Musgrave, et al. (1987), these taxes impact on the economy at various points in the circular

flow of income and expenditures.[1] The classification of taxes on this basis is particularly useful in determining tax incidence:

1. they may be imposed in the product or in the factor market;
2. they may be imposed on the seller's or buyer's side of the market;
3. they may be imposed on households or firms; and
4. they may enter on the sources or the uses side of the tax payer's account.

The use of multiple bases exists for political and social as well as economic reasons. In reality, the true well-being, or ability to pay, of individuals cannot be adequately reflected by one single indicator. Circumstances such as health, marital, and family status vary substantially among individuals and directly affect the benefits they receive from public expenditures. Individuals also vary in terms of the utility they derive from work and leisure, and from consumption and saving. This point has been emphasized by Atkinson and Stiglitz (1976) who argue that:

> the necessity for any form of taxation other than a uniform lump-sum tax arises from the fact that individuals have differing characteristics (endowments or tastes). If we could observe all relevant characteristics costlessly and perfectly, we should be able to achieve a first-best solution. However, in practise we have to make use of surrogate characteristics, which are related systematically to the characteristics on which we would like to differentiate individuals, but which are not perfectly correlated and which are, to some extent, under the control of the individual. Certain ethical principles, notably those which fall under the rubric of horizontal equity, limit further the set of surrogates which may be used. Having established an admissible class of characteristics, the problem then becomes one of determining which are to be employed (the choice of tax base) and the structure of the tax schedule.[2]

The mixture and noncompatibility of the tax objectives, described in Chapter II, also result in the need to apply various types of tax. Different taxes offer different mechanisms to achieve the chosen objectives of tax design and the use of a variety of tax bases provides the additional flexibility to implement competing objectives simultaneously. This may also enable governments to minimize the inevitable trade-offs among taxation objectives. On a more practical level, levying all required revenues through one tax would compound the inequities and distortionary effects of this particular tax and could involve severe compliance problems.

A government's choice of tax base will also be influenced by certain economic characteristics of the jurisdiction involved. Chapter II indicated that the mobility of factors will result in tax shifting, with an effective tax burden that may be unintended. For instance, the burden of factor taxes may be shifted onto the less mobile elements of the economy, such as land and unskilled labour. Revenue stability may also be a concern for governments. To the extent that incomes fluctuate more than consumption over time, the latter will be a more stable source of tax revenues. The relative importance of household production that results in imputed incomes could also be an issue in determining the proportion of revenue to be derived from income taxes, as opposed to other taxes such as sales or property taxes.

Finally, in a federation such as Canada's, the issue of the choice of tax base is also related to the legal and constitutional division of taxing powers. The Constitution Act of 1867 confers upon the Canadian Parliament legislative competence over the raising of money by any mode

or system of taxation, including the exclusive right to impose customs and excise duties. Section 92 of the Act confers upon the provinces, to the exclusion of the federal government, the power to levy direct taxes within the province in order to raise revenues for provincial purposes. The Act also authorizes provinces to delegate taxing power to their municipalities. Essentially, two concepts define the dividing line between federal and provincial taxing powers: "direct taxation" and "within the province."

The definition of "direct" and "indirect" taxes, in vogue at the time of the drafting of the British North America (BNA) Act, was that of John Stuart Mill. A direct tax is one which is demanded from the very person who it is "intended or desired should pay it." Indirect taxes, on the other hand, are "those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another."

Typical examples of indirect taxes are import tariffs, export taxes, and excise taxes. These were reserved for the federal government to ensure the preservation of an internal common market and to prevent the provinces from taxing persons outside their borders. In 1867, indirect taxes raised considerable revenue while direct taxes (property taxes, income taxes, death duties) were unpopular and thus of limited practical use in raising revenue. This was seen as compatible with the small expenditures on education, welfare and local public works then undertaken by provincial governments.

As the revenue needs of provincial governments grew, the expansion of direct taxation followed. The courts upheld the original definitions of "direct" and "indirect" taxes, using them as a legal tool to make rulings, irrespective of the fact that the terms had become meaningless from the point of view of modern analysis of tax incidence. The result has been that, with a few exceptions, most taxes are legally viewed as direct. The form of the tax, not its substance, is the deciding factor.[3] For example, the retail sales tax is a direct tax because the seller is viewed as an agent of the government, collecting the revenue directly from the purchaser. Thus, the restriction of a province to the relatively broad field of direct taxation entails little restriction on the province's ability to restructure its tax system as it wishes.

The second, and currently more important, limitation is that a province can impose a tax only within its own geographical boundaries. As Sheppard (1986) states, "the courts deal with this issue by identifying the subject matter of the tax and then locating it either inside or outside the province. A tax imposed on a person or thing outside the province is beyond provincial legislative competence."[4]

Beyond these constitutional limits, the federal-provincial tax collection agreements also limit the extent of provincial control in defining the tax base. Nine of ten provinces have a tax collection agreement with the federal government whereby the latter agrees to collect personal income taxes on behalf of the provinces if a common tax base, defined by the federal government, is accepted and applied. Seven provinces have similar agreements with respect to the corporate income tax.

3. Choosing a Tax Mix

Tax systems are usually designed to incorporate a tax mix, so that revenues will originate from both direct and indirect taxation. The tax mix will reflect some design choices as to the appropriate combination of these two forms of taxation. Several considerations will be taken

into account such as the revenue potential, the ease of enforcement, the ease of evasion, as well as the rating of each type of tax in terms of the basic criteria of equity, efficiency, and simplicity.

As indicated above, the traditional distinction between direct and indirect taxes is based on Mill's definition, which describes direct taxation as a tax imposed upon the person who is intended to bear the final burden of the tax. Indirect taxation describes a tax levied upon others than the person who is intended to bear the final burden. This definition has been used for constitutional purposes to establish the taxing jurisdictions of both the federal and provincial governments. It is important to note that in this context, the issue of tax incidence has referred to the legal, rather than the economic, incidence of taxes. In this chapter we refer to the distinction between direct and indirect taxation within the context of economic incidence.

The distinction between direct and indirect taxes can be related to the circular flow of income and expenditures. Direct taxes would be the ones levied directly on the sources side, that is, on income before it is used, while indirect taxes are the ones levied on the uses side on the basis of this use. However, some conceptual fuzziness remains when trying to distinguish between direct and indirect taxes, apart from the issue of legal *versus* economic incidence. For instance, several authors characterize direct taxes as those that can be adjusted to reflect the circumstances of the taxpayer, while indirect taxes are those levied at rates independent of taxpayers' attributes.[5] According to Thirsk (1985), identifying the effect of a tax on relative, rather than absolute, prices may be a more reliable procedure to distinguish how one tax differs from another. "Taxes will diminish the welfare of households either through a reduction in their money incomes, through an increase in the price of their purchases, or through a combination of both."[6]

The impact of a direct tax tends to be observed on money income while that of an indirect tax is reflected by increases in the price level. Although the price level manifestations are quite different for the two types of tax, it is possible for a direct tax (a single rate expenditure tax) and an indirect tax (a broad-based uniform value-added tax) to have an equivalent impact on the structure of relative prices. In such a case, the distribution of income and the allocation of resources would be the same under either tax. This is clearly significant given certain reform trends. Carlson and McLure (1984) point out that the flat rate personal income tax, that was proposed in the United States on several occasions in the early 1980s, was practically equivalent to a broad-based uniform rate value-added tax that allows personal exemptions.[7]

However, the important issue is not how to distinguish between direct and indirect taxes, but rather to assess "how each type of tax may contribute to the achievement of the trinity of goals that serve as the hallmark of a good tax system: equity, efficiency, and administrative ease."[8] Two views have emerged with respect to the appropriate role of indirect taxes in a tax system. If we ignore questions of administration, it can be argued that direct taxes are superior under both equity and efficiency criteria since these taxes have the built-in capacity to take account of taxpayers' circumstances. They are more likely to be compatible with horizontal equity objectives and may, if broadly based, be less distortionary than indirect taxes. The other point of view is that direct taxes should be used to achieve the equity objective, while relying on indirect taxes to raise enough revenue so as to permit reasonable marginal tax rates for the direct taxes. As Thirsk (1985) notes:

> For a given revenue requirement, marginal tax rates would be higher with exclusive reliance on a single direct tax base. Introducing an indirect tax base, even though it might detract from the equity objective, would permit lower marginal tax rates on the direct tax base and since efficiency is a function of the square of the marginal tax rates, the combination of direct and indirect tax bases would impose a lower efficiency cost on the economy than would the use of the direct tax base itself.[9]

However, Thirsk further indicates that these propositions, derived from the optimal tax literature, do not rest on very solid theoretical ground and the results of studies in this area are as of yet inconclusive. Basically, the rationale for implementing indirect taxation depends upon revenue needs and the type of direct tax that is in place; that is, whether it is a broad-based income tax, or a broad-based expenditure or consumption tax.

As indicated in Chapter II, one's assessment of the equity of the tax system is very much dependent upon one's view as to the appropriate indicator of well-being or ability to pay. As Kaldor (1955) has pointed out, it appears that over time, the notion of income has become synonymous with taxable capacity.[10] The Haig-Simons concept of comprehensive income is probably the most widely accepted measure. It is defined in terms of "use" as the sum of current consumption plus additions to net worth or saving, and in terms of "source" as the sum of all real current additions to purchasing power.

Ideally, the comprehensive income tax base should include labour income, real and imputed rents, dividends, interest, transfers, accrued capital gains, gifts and inheritances, and the value of household services. It should permit deductions for expenditures that do not increase consumption or wealth such as maintenance and repair costs, or business operating costs. Such a tax base was the ideal espoused by the Carter Commission in the 1960s. Today, it is the yardstick generally used to evaluate tax systems.

However, there are several conceptual and practical difficulties encountered in trying to implement a comprehensive income base. The equal treatment of all sources of income is certainly desirable in theory. In practice, however, this would involve the inclusion of all sources of imputed income including leisure income and rental income from owner-occupied housing. Not only are there technical and practical problems in measuring these various forms of income, but also the taxation of such intangibles is likely to be perceived as unfair. Capital gains taxation is another problem area. Taxation on an accrual basis is generally considered impractical. This approach would involve imputing changes in asset values and tax liabilities for taxpayers on gains not yet realized. The usual procedure has been to tax capital gains on realization, which can be seen as impeding the efficiency of capital markets due to the incentive to postpone realization in order to defer tax payments. It effectively provides the taxpayer with a tax averaging device which creates inequities if annual income is viewed as the proper tax base.

Other difficulties associated with the implementation of a comprehensive income base include the need to account properly for inflation in measurements of capital income, deductions, and tax brackets. There is also the need, in the presence of both a corporate and personal income tax, to integrate the two systems to avoid double taxation of some sources of capital income and to prevent certain types of income from escaping taxation altogether. The issue of fluctuating incomes brings into question the appropriate timeframe underlying the tax base, since the use of annual income certainly results in inequities.

The concept that people should be taxed on what they consume or take out of the social pot, rather than on what they earn or contribute, can be traced back to the 17th century with the writings of Hobbes. However, there has been renewed interest in this approach in recent years, particularly following the Meade Committee report in the United Kingdom (1987) and the U.S. Treasury's Blueprints for Tax Reform (1977).[11] There are several factors contributing to this interest. First, it can be argued that a consumption base is more equitable. Boadway and Kitchen (1984) state that "consumption expenditures represent a better indicator of a taxpayer's well-being than does income since it is consumption that ultimately yields satisfaction, not income."[12] Second, a consumption tax eliminates one of the major negative effects of the income tax, namely, the disincentive effect on savings resulting from the taxation of interest, dividends and capital gains which reduces the return to savings. Finally, the most severe difficulties in implementing an ideal comprehensive income base are eliminated under a consumption tax. The tax base is equivalent to the difference between current income and net savings and therefore, there is no need to include accrued capital gains or to index the base for inflation.

There are three different ways to define a consumption tax base. In its pure form, the consumption tax would be levied on realized income less the net accumulation of financial and real wealth (including consumer durables) plus the current services of consumer durables. However, as is the case with imputed rent, measuring the flow of services from durables is difficult. A second way of treating durables is on a cash-flow basis where the expenditures on durables are included in the tax base as opposed to the value of their services. A third variation on the consumption tax theme is the wage tax or the tax prepaid approach. This is essentially an income tax with all capital income exempt. Under this approach, there is no deduction for savings or investment in assets, but neither is the income from those investments taxed. Each of these three tax bases is equivalent in present value terms. However, the true consumption tax base would involve considerable tax liabilities in the earlier years of life when consumption is relatively high and sometimes greater than income. On the other hand, the cash-flow approach, because of the inclusion of durables, would tend to be lumpy, and tax liabilities would probably occur even earlier in time. As for the wage tax approach, the exemption of capital income eliminates some liquidity problems of the former two bases, and the tax liabilities are more easily financed since they are closely related to income.

Wealth can also be used as a direct tax base. However, difficulties associated with achieving a proper market value assessment of the various forms of wealth, including human capital, and the problems of enforcing a tax on such a base, makes a true wealth tax disadvantageous. The property tax levied on real property is essentially the only form of wealth tax commonly used in most societies, even though the paid-up capital taxes levied in several provinces are categorized by some as a form of wealth tax. Chapter IX discusses these particular taxes in more detail.

According to Buchanan and Flowers (1975), the personal income tax meets the criterion of directness more than any other tax that can be used as a major source of revenue in modern fiscal systems.[13] In Canada, the PIT is the most important federal and provincial revenue producer. Boadway and Kitchen's (1984) review of the tax suggests that:

> the personal income tax is the fairest form of taxation available. Its potential effect on the behaviour and on the supply of labour is far from obvious. There is little, if

any, support for the contention that the personal income tax has retarded economic growth.[14]

The major criticisms directed at the PIT are more likely related to the fact that:

(1) An ideal income-based PIT is impractical due to the difficulties in measuring and including accrued capital gains in the tax base, and due to the issues of proper treatment of inflation and full integration with the corporate income tax.

(2) Because of these and other difficulties, various sources of income are taxed at different effective rates causing distortions and inefficiencies, as well as inequities.

(3) The resulting exclusions, deductions and special provisions involve considerable administrative and compliance costs. Consequently, higher marginal rates are required which further compound the distortionary effects of the tax.

(4) The PIT, because of the way it is designed and enforced, is susceptible to tax evasion and avoidance.

The position that the personal income tax has a detrimental impact on savings and investment has, until recently, received some credibility in spite of a lack of evidence. Indeed, several of the current and pre-reform Canadian provisions in the PIT, such as the deduction for interest and dividends, the capital gains exemption, and the RRSP deductible contributions, can be seen as an explicit effort to counteract the impacts on savings and investment. As a result of these measures, a PIT would shift somewhat towards a consumption-based tax, and away from an income-based tax. However, the 1987 Canadian White Paper reform proposals and the reforms implemented since 1987 have indicated an overall reversal in this approach to comprehensive income taxation.

Although the personal income tax (a direct tax) remains, on average, the most important source of revenue, governments also rely upon a variety of indirect taxes to help finance their expenditures. Thirsk (1985) notes that the structure of these taxes can vary widely as can their characteristics.

> The transaction to which the tax applies may be either an act of production by firms in the economy or an act of consumption by households. Except in an open economy, it does not matter in principle on which side of the market, supply or demand, an indirect tax is assessed. Indirect taxes may apply to a large number of transactions, in which case they are described as sales taxes, or to only a few transactions. With such a limited scope, indirect taxes are referred to as excise taxes. The base for an indirect tax is either the price of the transaction (ad valorem taxation), as in the case of sales taxation, or the quantity transacted. The rates of indirect tax may be either uniform or variable across different kinds of transactions.[15]

The rationale for excise taxes is unrelated to the choice of direct tax.[16] For instance, these taxes can be used to serve the equity objective by exploiting the differing income elasticities of demand for various commodities. Taxes levied on the consumption of luxury items have traditionally been used for this purpose. Similarly, by exploiting the differing price elasticities of demand for various commodities, excise taxes can be used to collect revenues while minimizing efficiency costs. Also, to the extent that a tax can be targeted on consumption directly related to benefits received from certain public expenditures, the benefit principle of taxation may apply. Taxes on gasoline consumption, which is complementary to public highway usage, may be categorized as such. Finally, excise taxes on products such as tobacco and alcohol may be justified because the consumption of these products is believed to

generate negative externalities for society as a whole, which are costly in terms of loss of productivity and higher health care and crime prevention expenditures.

On the other hand, the case for a general sales tax is related to the type of direct tax in place. As is emphasized throughout the literature, perhaps the most serious distortion attributable to the broad-based income tax is the fact that it favours an inefficient, inter-temporal allocation of resources by giving preferential treatment to current consumption over future consumption. Restricting the use of the PIT by relying on a general sales tax, such as a broad-based VAT, has the advantage of limiting the severity of this distortion. As for the work-leisure distortion associated with the PIT, the use of a general sales tax could be advantageous in this case as well. However, in order for a sales tax not to distort the work-leisure choice, it would be necessary that a tax illusion take place. It would be necessary that the taxpayer not perceive that the reduced tax burden of the PIT is matched by the increased tax burden of the sales tax. There is no evidence that such an illusion does operate.

Another argument on the role of indirect taxes concerns the fact that in present value terms, a single rate general indirect tax could be equivalent to an equal rate payroll tax on labour incomes. These two taxes would differ to the degree that consumption of existing wealth bears tax under the consumption tax, but not under the labour income tax. These two taxes could also differ in an open economy in regard to incidence on exports and imports. Relying more on a general sales tax would lighten the tax burden on income from capital under the PIT, thereby moderating savings inefficiencies. Personal income tax reforms that would move away from consumption tax measures would add weight to arguments in favour of indirect taxes.

Perhaps the more important arguments in favour of using sales taxes relate to the fact that the current PIT is subject to much more evasion and avoidance than the sales tax and the fact that broad-based indirect taxes are an efficient revenue raiser. This practical element would also be a factor in the presence of an expenditure tax where the latter could be applied mainly for equity reasons at a multiple rate on high-level consumers. Other less significant benefits in such a case would be that the flat sales tax could act as a cushion against the imperfect averaging and the labour-leisure choice distortions which would occur if only a progressive expenditure tax were in place. Thirsk (1985) concludes that:

> A mixture of direct and indirect taxes may be better able to achieve the goals of equity, efficiency and administrative simplicity under either a pure income tax system or a pure expenditure tax design. Much depends on the form of indirect taxation.[17]

To obtain the benefits from indirect taxation, it is important that such taxes adhere as closely as possible to the basic principles of sales taxation. As Cnossen (1985) notes, these include production and consumption neutrality.

> Production neutrality is achieved if a sales tax does not induce firms to change the forms and methods by which they carry out business....A sales tax should also be neutral in its effects on consumer choices; that is, the actual tax incorporated in a consumer price, expressed as a percentage thereof, should equal the nominal or statutory rate of sales tax.[18]

Furthermore, in light of the criteria of interjurisdictional equity, locational neutrality, and administrative feasibility, the destination principle emerges as the preferred basis; that is, the commodity is taxed in the jurisdiction where it is consumed. According to Cnossen, only the

retail sales tax and the value-added tax come close to meeting the neutrality requirements. These taxes are also the only ones suitable in terms of implementing the destination principle.

In the opinion of many, reliance on an expenditure tax should be accompanied by a tax on gifts and bequests. If a person chooses to give wealth to others, then that person may be seen as gaining utility from the process. In view of this, some would argue in favour of including taxation of gifts and bequests as part of each province's tax mix. A difficulty arises, however, in that if certain provinces do tax gifts and bequests while others do not, then wealthy individuals may shift their official residence in order to avoid this tax. In this process, provinces may compete in order to attract wealthy residents by reducing or eliminating such taxes. Some would suggest that in fact this has been the Canadian experience. The issue of interprovincial coordination of taxation is consequently of particular importance from this perspective.

To summarize, there is a case to be made for using a general form of indirect taxation in combination with a direct tax, even if an ideal form of direct taxation were possible, but particularly because it is not. Indirect taxation does not lend itself easily to pursuing equity objectives (particularly horizontal) because it does not recognize taxpayer attributes. Credits against the PIT might be a way to counteract the regressivity of sales taxes. The retail sales tax and the broad-based VAT are clearly the preferred options in terms of meeting the basic principles of sales taxation. However, the RST currently levied in most provinces could be improved by eliminating exemptions (which in many cases are unwarranted) and exclusions (which create non-neutralities), and by reducing the taxation of capital goods and intermediate inputs as much as possible. These issues are discussed in more detail in Chapter VIII.

4. The Choice Between a Broad or Specifically Designed Tax Base

Of all the taxes currently levied in Canada, there is not one that could be described as a true broadly-based tax. The PIT is significantly narrowed by numerous exemptions, deductions, and exclusions from the tax base, which is in fact a combination consumption-income tax base. The CIT provides accelerated depreciation allowances, investment tax credits, as well as various deductions and diverse rates related to specific types of economic activity. The federal MST is notorious for its numerous exemptions and exclusions from the tax base, its poorly specified tax base, and its application of more than one rate. At the provincial level, the only general type of tax is the RST. The provincial RST can be recommended for its uniform rate and well-defined base, but it too is subject to numerous exemptions (food, clothing, utilities) and exclusions (services). Both the MST and RST are imposed on some business inputs and investment goods, resulting in tax cascading and distortions.

As a rule, any tax provision that introduces non-neutralities will result in efficiency loss. As Boadway and Kitchen (1984) state, "[f]or complete neutrality, the imposition of a tax must affect all forms of economic behaviour in exactly the same way."[19] The current tax system is far from neutral. The deductions and exclusions from the PIT base result in a different tax treatment being applied to income from different sources. The special CCA provisions, the investment tax credits, and the imposition of different tax rates under the CIT contribute to the wide range of effective tax rates among industry groups, as well as activity groups (for example, services, manufacturing, and resources-related groups). Nevertheless, some of these CIT provisions, such as the investment tax credit and accelerated CCA, can serve to reduce the

intertemporal distortions caused by a CIT. The exemptions from the sales tax effectively distort consumption behaviour between taxed and untaxed goods.[20]

The rationale for these tax provisions varies in each case. For instance, the exemptions from the sales tax have a number of purposes. Food, prescription drugs, and sometimes clothing are exempt in order to remove some of the tax burden on low-income taxpayers, associated with the purchase of items considered as necessities. This is seen as improving the fairness of the tax and therefore its acceptability. Other exemptions are provided to encourage the consumption of these goods according to specific economic goals, or to eliminate multiple taxation as in the case of goods used in the production process. The latter example would be seen as improving efficiency. As already mentioned, the impact of the distortions caused by these exemptions is directly related to the elasticities of supply and demand involved, and the level of the tax rate.

The special provisions provided under the CIT, on the other hand, occur mostly in the context of the economic growth objective. For the most part, they operate to provide an incentive (or disincentive) for the purchase of assets for particular uses or by particular industries. Such is the case with the accelerated depreciation allowances and the investment tax credits available for instance to manufacturing, processing, and mining industries (in particular, those operating in designated regions). Specific types of activities (for example, special provisions to facilitate research and development) have also been explicitly encouraged and favoured.

The reasons for the numerous exemptions and deductions from the PIT base can be categorized broadly in terms of two objectives: those aimed at achieving certain social goals, including improving horizontal and vertical equity, and those aimed at encouraging saving and investment. Personal exemptions and deductions for medical expenses, charitable donations, education costs, social insurance and child care expenses qualify under the first category of objectives, while deductions for RRSPs and tax exemptions for interest, dividends and capital gains involve the second objective.

The important fact to consider in this discussion is that special tax provisions can significantly narrow the tax base. This process involves direct costs in terms of tax revenues foregone, and indirect costs in terms of the losses incurred from the misallocation of resources in the economy.[21] In addition, tax exemptions and deductions usually result in the need for higher statutory rates which further exacerbates the distortionary effects of taxes. These costs must be weighed against the benefits to be gained from the tax provision, and they must be considered in the context of whether these benefits might not be obtained more efficiently through other means. For instance, it has been argued that sales tax exemptions on items such as clothing do not reduce the regressivity of the sales tax, and that perhaps a sales tax credit against the PIT would be a more effective way to reduce the tax burden on low-income individuals.[22] In fact, tax credits have recently been implemented as a replacement for personal tax exemptions and deductions. This is seen as an improvement from an equity standpoint because the value of the latter effectively increased as the marginal tax rate rose. These views are strongly reflected in the 1987 White Paper proposals and the 1988 Income Tax Reforms.

Finally, tax incentives have come under criticism in the United States and Canada for creating wide margins in effective tax rates between industries, and more important, for becoming a determining factor in the business decision process while not necessarily providing

the desired impact. It has also been argued that many of the redistribution and economic incentive objectives may be better served on the expenditure side of the budget equation. Unfortunately, it is very difficult to assess these arguments objectively given the lack of consensus as to the relative value of the trade-offs between the basic objectives underlying tax design.

5. Choosing The Rate Schedule

Another area of choice in tax design – although mainly in the context of the personal income tax – is that of the rate structure. The issue in this case is to achieve, through the structure of marginal tax rates, a certain degree of progressivity which would result in a higher tax burden for those with higher ability to pay. The degree of progressivity in the PIT is also seen as a means of compensating for the regressive nature of other taxes such as commodity taxes. However, there are a number of elements which make the choice of tax structure not as straightforward as might appear.

For one thing, the degree of progressivity is related to a great extent to the choice of indicator of ability to pay. Statutory rates are such that tax payments will undoubtedly increase more rapidly than taxable income. However, because of all the exemptions, deductions, and exclusions from the tax base, the progressivity of the tax will be severely reduced if one uses annual comprehensive income as a basis for comparison. One of the basic points of the U.S. Treasury I (1984) tax reform proposal was, that by eliminating many of the exemptions and deductions which erode the tax base, it is possible to move from fourteen to three substantially lower tax rates without dramatically decreasing tax progressivity. This argument also supported the Canadian 1988 reforms to the PIT rate structure. The perceived degree of progressivity of a specific tax structure would also be substantially different if an annual or lifetime consumption base were used to assess equity.

Other elements to consider in determining the adequate tax rate structure are the disincentive effects of progressive taxation on work, saving and investment, the added incentive to escape or avoid tax, the relation of tax payments to benefits received, and the potential of the tax as an automatic stabilizer by means of the rate progression.

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8. Thirsk, p. 6.

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11. U.S. Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington, D.C.: Government Printing Office, 1977).

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14. Boadway and Kitchen, p. 120.

15. Thirsk, p. 2.

16. See for example, Kesselman.

17. Thirsk, p. 15.

18. S. Cnossen, "Sales Tax Coordination," in *Proceedings of the Thirty-Seventh Tax Conference* (Toronto: Canadian Tax Foundation, 1985), p. 14.

19. Boadway and Kitchen, p. 266.

20. See for example, M. Daly, J. Jung, P. Mercier, and T. Schweitzer, *A Comparison of Effective Marginal Tax Rates in Canadian Manufacturing*, Economic Council of Canada Discussion Paper, No. 293 (Ottawa: The Economic Council of Canada, 1985).

21. Although RRSP deductions may reduce the inter-temporal distortions associated with the PIT, and the dividend deduction may relieve the double taxation of dividends under the PIT and CIT, the result of these provisions is effectively to tax different sources of capital income at different rates. The net impact is unclear.

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Chapter IV

Harmonization: The Case For and Against

1. Introduction

This chapter considers the rationale for reserving certain kinds of taxes for the federal government, and prohibiting provincial involvement in those taxes. It also considers the rationale for harmonizing provincial taxes so as to maintain a uniformity across the country.

From the perspective of Canadians as a whole, it can be argued that certain kinds of taxes should be reserved for the federal government. In particular, pursuit of the equity objective may justify federal responsibility for income redistribution so as to achieve a uniform degree of equity in all regions of the country. This would imply that taxes involving progressivity should be reserved for the federal government. Furthermore, taxes that can be shifted readily should, on this basis, be reserved for the federal government so as to prevent any one province from imposing a tax burden on the residents of other provinces. Pursuit of the efficiency objective may justify tax uniformity among the provinces, so that interprovincial movements of people and investments will be based on efficiency criteria rather than tax considerations. This is particularly important because most provinces are small open economies where labour and capital could, in fact, flow easily among them in response to differences in tax structures and rates. Yet tax harmonization may not entail complete equality of tax rates, since some provinces may provide more services than others. Higher tax rates may be appropriate and necessary to pay for these additional services.

The view that unemployment and inflation are national issues might also give the federal government the responsibility for stabilization aspects of tax policies, and it might support federal control over those taxes that can be used most effectively for fiscal policy. Furthermore, if significant tax differences did exist among provinces, then administrative and compliance costs could also become a serious issue. Here the objective of tax simplicity in

order to minimize administrative and compliance costs may also be important in the determination of the appropriate scope for provincial reform options.

Nevertheless, considerable differences do exist among provinces, and these may justify a variation among provinces in their reliance on alternative tax bases, designs, and rates. Certainly, income levels and unemployment rates have differed greatly and have created different needs in regard to growth and job creation. Furthermore, a nation may not be homogeneous in regard to citizens' preferences. The relative weights to be placed on the tax reform objectives may vary among provinces for political reasons. For example, different attitudes towards reliance on benefit taxes have resulted in significant variations in user fees for post-secondary education and health insurance. Even the stabilization role may be seen as a provincial responsibility to the degree that business cycles vary among geographical regions. In practice, however, the small open nature of provincial economies imposes a practical constraint on the ability of each province to deviate from the norm. Labour and capital could readily shift among provinces.

Finally, this chapter considers the federal-provincial tax collection agreements. Most provinces have given the federal government the right to establish rules and regulations concerning the PIT and CIT. In return, the federal government administers and collects taxes on behalf of these provinces. This has severely limited the flexibility of each province in regard to the PIT and CIT. An argument can be made in favour of modifications in the agreements to increase the scope for provincial options in tax reforms.

For many people, these issues are influenced by one's view of federalism. Why should provinces exist as separate governmental structures? If provinces are to exist, what should their responsibilities be? In view of their responsibilities, what should their powers of taxation be? The answers to such questions influence people's attitudes towards the appropriate degree of independence in provincial choices of tax mix, and consequently the acceptable degree of differences among provinces in tax mix. For some people, the political desirability of separate and independent provinces may even justify inefficiencies in the tax system, if these inefficiencies arise from the right of provinces to establish separate tax systems.

Closely related to one's view of federalism, is one's opinion in regard to the benefits to be derived from competition among governments. For some people, strong provincial governments with separate tax systems may provide a very useful balance to the federal government. Strong provincial governments may serve to restrain the otherwise excessive power of a single federal government.

2. The Division of Tax Powers and the Harmonization of Provincial Taxes

A substantial body of literature has focused on the division between the levels of government in a federation of different types of taxes and tax bases . Much of this literature is based upon theoretical analysis that is applicable to any federal state. Illustrations are frequently drawn from Switzerland, West Germany, Australia, and the United States as well as Canada. As the literature indicates, certain types of taxes and tax bases may be more appropriate for a particular level of government. In determining the appropriate allocation of tax jurisdictions between national and sub-national governments, the equalization or harmonization of both

tax bases and tax rates across the sub-national units also become issues of concern. It is to these questions that we now turn.

In presenting a rationale for a particular division of tax powers, authors usually build their argument around the need to reserve particular types of taxes for the federal government. The argument is often two-pronged, emphasizing issues of equity and also issues of efficiency. From the perspective of equity, some authors believe that taxes should affect citizens living in different geographical areas in similar ways and to a similar degree. For tax purposes, it should not matter to a citizen where he or she lives within the federation. The implications of this national perspective are very important. It should be a matter for the federal government to decide upon the appropriate degree of income redistribution. Taxes that entail progressivity should either be reserved completely for the federal government or, alternatively, the sub-national governments should simply "piggy-back" on these types of taxes by setting their tax rates as a percentage of the federal tax payable.

From the perspective of equity, taxes that can be shifted backward or forward should be reserved for the federal government. If this were not done, then a sub-national government could shift the burden of public expenditures from its own citizens to the residents of some other geographical area within the same nation. Sub-national governments should levy taxes that are borne as completely as possible by the residents of the taxing jurisdiction. In this way, the residents of each sub-national unit pay for the public services that they receive. Again, for tax purposes, it should not matter to citizens where they live within the federation. This was the reason that the BNA Act restricted the provinces to the collection of only "direct" taxes.

A number of efficiency issues support this division of tax powers. For the maximization of aggregate national income, it is necessary that factors of production be located geographically on the basis of efficiency criteria rather than tax considerations. Within a nation, citizens and investment can both move quite readily from one geographical area to another. If the sub-national governments were to impose different tax structures, then factors of production would include tax considerations in their decisions about where to locate. One could expect that a sub-national government would consciously choose a tax structure so as to attract people and investments that it deemed desirable. The resultant competition among sub-national governments could intensify the distortionary effects caused by different tax structures.

Some authors emphasize that responsibility for stabilizing the economy should also rest with the federal government. Some view recession and inflation as national issues, requiring the judgement and action of the federal government. They believe that only the federal government is able to coordinate tax and expenditure changes so as to attain full employment with minimal inflation. Since monetary policy must be a national government responsibility, it is clear that the coordination of monetary and fiscal policy requires that fiscal policy be in the hands of the national government. In addition, the coordination of changes in taxes among sub-national governments would, in practice, not be possible. Differences of opinion, as well as the mechanics of negotiation, would preclude coordinated action.

This stabilization argument leaves in the hands of the federal government those taxes that are best used for fiscal policy. As indicated in Chapter III, the progressive personal income tax is usually seen as the best tax for automatic stabilization. Taxes allocated to sub-national governments should be those with a stable revenue, not affected by business cycles. Again, to the degree that a sub-national government utilizes taxes that play a major role in

stabilization, it should "piggy-back" those onto federal tax payable, as a certain percentage of the latter. A further practical consideration supports this position. Usually a federal government can finance deficits at a lower interest rate and with less administrative expense than can sub-national governments.

These general principles of tax assignment are described by Professor Richard Musgrave (1983) as follows:

> Suppose that a given set of central, state, and local jurisdictions, in the process of forming a federation, confront the issue of tax assignment. The available taxes are personal income tax, corporation profits tax, destination-type consumption tax (retail sales tax or VAT), and property tax. What is their suitability for each level? An obvious minimum requirement for each jurisdiction is to adhere to the rules of good tax manners . . . That is to say, there should be a minimum of export burden, with each jurisdiction restrained (in the absence of benefit spillover) to tax its own bases only. The following assignment rules then seem appropriate:
>
> 1. middle and especially lower level jurisdictions should tax those bases which have low interjurisdictional mobility;
> 2. personal taxes with progressive rates should be used by those jurisdictions within which a global base can be implemented most efficiently;
> 3. progressive taxation, designed to secure redistributional objectives, should be primarily central;
> 4. taxes suitable for purposes of stabilization policy should be central, while lower level taxes should be cyclically stable;
> 5. tax bases which are distributed highly unequally among sub-jurisdictions should be used centrally; and
> 6. benefit taxes and user charges are appropriate at all levels.[1]

In the Canadian context, Thirsk (1984) has been more specific in regard to the division of tax powers. His use of the phrase an "open economy" refers to the ease with which labour and investment can flow from one sub-national area to another within a federation.

> Residence-based taxes levy a burden on income earners where they enjoy or spend their income. Source-based taxes, on the other hand, impose their burden at the point where income is earned or produced. The counterpart of these concepts in the area of commodity taxation are the destination and the origin principles. Under the destination principle commodities are taxed at their point of consumption, while under the origin principle commodities are taxed at their point of production. In closed economies, where resources are immobile and trade flows nonexistent, these distinctions are unimportant. They take on greater relevance, however, in an open economy, which is the kind of economy that is likely to confront sub-federal levels of government.
>
> In the framework of an open economy, the residence and destination principles of taxation are at once more efficient and more equitable than the source and origin principles. For one thing, a sub-federal jurisdiction that elects the former principles rather than the latter is much less likely to be able to export its tax burdens to other jurisdictions – a source of both inefficiency and inequity. Moreover, the destination principle of commodity taxation is much less likely than the origin principle to disturb the pattern of interregional trade flows in a federation. Similarly, the residence principle is much less likely than the source principle to distort the allocation of capital resources in a federation, since it taxes the income received from the ownership of capital rather than the income earned by that capital. The

> residence principle is also likely to be more equitable than its source alternative, since under the residence principle tax liability is related to the total amount of income that a person receives and is not affected by where he earns it.
>
> The policy implication of this discussion is that sub-federal levels of government should eschew both source – and origin-based taxes. In the Canadian context, this would mean that the provinces would vacate the corporate tax field and receive a much smaller share of natural resource revenues – a share that would be determined on the principle of benefit taxation – and that municipalities would be required to cease their taxation of nonresidential property. Provinces and municipalities would draw their revenues jointly from some combination of personal income taxes, taxes on retail sales to provincial consumers, and residential property taxes.[2]

A number of the arguments supporting similar tax structures across sub-national governments also support similar tax rates across sub-national governments. Different tax rates would mean that labour and investment location decisions would be affected by tax considerations rather than solely by efficiency criteria. For the nation as a whole, this would mean a smaller national income than would occur with similar tax rates across sub-national governments. Furthermore, if one sub-national government were to manipulate its tax rates so as to attract desirable labour and investment, then other sub-national governments would no doubt join the competition.[3] Again, this competition and retaliation could create chaotic situations with rapidly changing tax rates and with no certainty that the result at any point in time would be efficient. Thirsk (1984) states that:

> . . . it is possible to argue that tax competition can have harmful results. Certainly, circumstances can be envisioned in which tax competition would be inferior to a cooperative approach to harmonization, or to any of the other ways of harmonizing taxes that have been discussed here. Because tax competition tends to harmonize tax rates at a relatively low level, it can lead to an inefficient level of government expenditure. Moreover, if tax competition occurs on a selective basis across industries, it can contribute to an inefficient inter-industry allocation of resources.[4]

In discussing the desirability of tax harmonization, it is important to realize that complete equalization of tax rates is not necessarily the objective. Thirsk (1980) has emphasized that "the notion of a fiscal residual provides the appropriate concept for interjurisdictional fiscal harmonization."[5] Each sub-national government should remain free to choose its particular combination of public services which it provides to its residents. A certain sub-national government may decide to provide more services than are provided by other sub-national governments. Higher tax rates are then necessary and appropriate in order to pay for these additional services. From this perspective, differences in tax rates among sub-national governments should be directly related to differences in expenditures. Complete equality of tax rates would be neither possible nor desirable.

We might note that tax differences based on expenditure differences provide a nation's citizens with an important freedom. The individual can choose to live in the particular geographical area where the sub-national government's combination of tax rates and expenditures is most to his or her liking. Tiebout (1956) in particular has drawn attention to this valuable attribute of the federal structure.[6] A citizen may face considerable freedom of choice in regard to the combination of public services and tax rates. In today's world where government expenditures form a very large proportion of total expenditures, this freedom may be significant.

Huggett (1977) has emphasized the difficulties of taxpayer compliance if sub-national governments have different tax structures and tax rates that are not harmonized. In particular, Huggett has warned that taxpayers may be subject to double taxation if two jurisdictions have different formulae for calculating taxable income, or if they lack a clear agreement for sharing their tax rights. At present, an allocation formula for the corporate tax has been agreed upon throughout Canada. However, taxpayers can still encounter complex difficulties, especially if they move into or out of Quebec, with its separate personal income tax. If every province had its own personal income tax system, these difficulties would multiply.[7]

Apart from administrative and compliance costs, a serious problem of separate systems is tax evasion. "When the same taxpayer has to pay income taxes to two or more authorities which have different definitions of taxable income, or which adopt different systems of progression, or between which there is a dispute as to primacy, that person is likely to be a more than usually unwilling taxpayer."[8] Even if one does not consciously evade taxes through illegal manipulations, nevertheless, one has a financial incentive to arrange one's business affairs among the various jurisdictions so as to minimize tax.

The provinces cannot ignore these arguments for tax harmonization amongst themselves or with the federal government. Nevertheless, a number of authors have suggested that a province can improve its economic achievements through independent tax initiatives, and it is to these suggestions that we now turn.

3. The Rationale for Differences Among Provincial Taxes

The above discussion has presented a number of reasons why a similarity in tax structures and tax rates would be appropriate within a federation. From this perspective, differences in tax rates would be advisable only so long as they related to differences in the public services provided by the sub-national governments. We shall now consider an alternative view, that differences may be justified for other reasons.[9]

The preferences of residents may differ so significantly among jurisdictions that uniformity is simply not feasible. Such differences may even extend to preferences for different types of taxes and different degrees of progressivity. Some commentators argue that stabilization needs also differ significantly among geographical regions and so a uniform national fiscal policy is not desirable.[10] "Failures" in the private marketplace may be more severe in some regions than in others – or they may be of a different nature. It may be argued that flows of labour and investment will tend to counteract any inefficiencies caused by tax differentials. Furthermore, in order to obtain similar after-tax income distributions it may be necessary to apply different degrees of progressivity among jurisdictions.

So far, our discussion has assumed that harmonization of nominal tax rates is at issue. However, it may well be the case that some taxes are shifted and the burden is borne by relatively immobile factors. If the degree of this shifting varies from one jurisdiction to another, true tax harmonization would require uniformity of effective, and not nominal, rates. The elimination of locational distortions would thus require different nominal rates of tax. The great difficulty in determining the incidence of tax, and thus the amount of tax shifting that occurs, makes the concept of tax harmonization difficult to put into practice.

To a major extent, these arguments rest on the view that geographical units within the federation are not in fact similar. The nation is not homogeneous with regard to preferences or economic circumstances. Consequently, citizens in the various jurisdictions should expect to receive different tax treatment. To a major degree, one's support for either perspective will rest upon one's perception of the purpose and nature of "nationhood." While we might automatically expect that individual preferences would vary among geographical regions, the real issue is the extent of these differences. Here we enter the realm of political judgement. For Canadians, the clearest illustration of this perspective can be found in the experiences of Quebec. Quebec has instituted a large number of tax changes that make its tax structure and tax rates significantly different from those of other Canadian provinces. The following table, concerning ways in which, in 1980, the Quebec Personal Income Tax departed from the federal government's structure, illustrates this point.

Table 4.1
Ways in which Quebec Personal Income Tax has Departed from Federal Income Tax

Revenue
- Non-indexing of tax rate table.

Equity or Redistribution
- Higher basic exemptions.
- Higher top rate.
- Different relief for children.
- Real estate tax refunds.
- Different rate progression.
- Higher benefit for company cars.
- Lower deductions for personal cars used to earn income.
- No education deduction.
- No housing loan exemption.
- Benefit from employee loan not computed on same basis.

Savings on Investments
- Current service contribution to RPP $5,500 rather than $3,500.
- Deduction up to $15,000 in stock savings plan.
- Investment credit of 25 per cent on SODEQ shares.
- Capital gains not eligible for $1,000 deduction.
- All interest expense deductible re $1,000 deduction.
- Capital loss deduction of $1,000 not $2,000.

Special Incentives
- $3 for $1 RHOSP contribution only.
- Quebec does not exempt employees' stock option benefits from tax as the federal measures do for private Canadian-controlled corporations.
- Contribution to RRSP limited to $3,500 if employee member of DPSP (federal now has the same limit when contributions to DPSP made in the year).
- RHOSP cannot be used to buy a house from the spouse in Quebec.
- For 1983 and following years contribution may be made to RHOSP but no deduction.

Miscellaneous
- Unpaid balance is always subject to interest charge; interest on refund starts only 60 days after filing or April 30th, whichever is later.
- Child care expense limits $2,000/child and $6,000/family instead of $1,000 and $4,000 federally.
- Limitation in deduction of legal fees to obtain maintenance payments (Que. 133.3); may be allowed by federal authorities (IT-99R).
- Differences in interpretation of the same legislation.

Source: Ontario Economic Council, *A Separate Personal Income Tax for Ontario: An Ontario Economic Council Position Paper* (Toronto: Ontario Economic Council, 1983), p. 34.

In many cases, the differences in Quebec's personal income tax structure may reflect different judgements concerning fairness and equity. Higher basic exemptions and higher top rates, different deductions for children, and different rate progression may be explained on this basis. Different child care expense limits and different technicalities, in regard to RRSPs and RHOSPs, may also reflect judgements concerning fairness and equity.[11]

We can see a number of differences in tax structures across Canada when we turn to user fees for education and health care. Significant differences exist among provinces in regard to tuition fee levels and health insurance fees. To what extent should the direct beneficiaries of education pay for their costs? To what extent does education provide social benefits to everyone? To what extent do all members of society owe an educational obligation to the young? Answers to these questions are a matter of political judgement, and there may be legitimate differences among provinces concerning the answers. Similarly, the levy of health care fees as opposed to reliance on other tax revenues may represent legitimate differences of opinion among provinces concerning society's obligations to pay for an individual's health care.[12]

One might expect that the intensity and duration of business cycles would vary among geographical areas. Again, the basic question concerns the degree of such differences. Canada's provinces have different resource endowments, different types of manufacturing, and different trade relationships with each other and with foreign nations. Some observers argue that these differences are so great that a national stabilization policy is not adequate. Each province must supplement the federal government's fiscal policy with its own independent action. This attitude could affect a province's choice of tax structure, and it could lead to differences in tax rates across jurisdictions in accordance with the current stabilization stance of each provincial government.

Barber (1980) expressed the opinion that in the post-1945 period, several Canadian economic cycles were caused by fluctuations in foreign demand for Canadian resource exports. These resource-based cycles, in turn, caused an oscillation in Canada's foreign exchange rate, and manufacturers in Ontario and Quebec have been hurt by this. For these reasons, a temporary foreign exchange rate shift may warrant counter-cyclical fiscal policy at the provincial level.[13] Wilson (1980) also argues that regional fiscal policy is best conducted by provincial governments. Provincial tax structures and rates must be determined locally in accordance with the provincial economic situation.

> As far as stabilization policy is concerned, it seems to me that the provinces in a region are in a better position to decide whether a regionally orientated stabilization policy is necessary – that is, whether they need to augment a particular federal policy or to offset its impact in the particular region.[14]

Wilson is pessimistic about the ability of the federal government to develop a regionally differentiated fiscal policy. Successful coordination among the provincial and federal governments in a unified fiscal program is not realistic. Too much time would be lost in federal-provincial consultations and hence, each province must act on its own. Fortin (1982) shares Wilson's positive attitude towards independent provincial stabilization policies:

> Given the considerable relative importance of the provinces in Canada's economy, the provincial budgets have a major impact on the regional and national business cycles, whether it be accidental or intentional . . . The principle of provincial participation in attempts to regulate the cycle is now well established in the theory and practice of stabilization policy in Canada.[15]

However, Wilson also notes that the ability to conduct an independent fiscal policy depends upon the extent to which residents make their purchases from outside the province. If the majority of provincial expenditures are on imports, then a provincial deficit will not have as much impact on local employment: rather, the deficit will be dissipated in "leakages." In particular, "the scope for provincial fiscal action is obviously much greater for provinces like Ontario, Quebec, and the major Western provinces than it is for the smaller provinces in the east, simply because the leakages are so much larger in the case of those smaller provinces."[16]

For some provinces, the long-term perspective of economic growth and job creation is a more important political issue than it is for others. For a number of reasons, the private market may not result in socially optimal production and consumption patterns. If the nature and extent of these market failures differ across the nation to a large enough degree, then differences in tax structures and tax rates may be justified on these grounds. For example, persistently high levels of unemployment have been a much greater problem in the Atlantic provinces than they have been in Ontario. Consequently, tax concessions to stimulate investment may be more appropriate in these provinces.

Within Canada, each province has a distinctive economic structure. One might argue that this requires a particular pattern of corporate tax exemptions and deductions. For example, the optimal public policy for Ontario may require a corporate tax structure that is different from that of Canada as a whole. As Table 4.2, and our later discussion of the CIT, indicates, a large number of such differences have arisen as a result of Ontario having its own corporate tax system, and these differences provide an indication of the large range of independent provincial initiatives that are possible.[17]

A significant constraint for an autonomous provincial tax policy is that the provinces are, in effect, small open economies. Suppose that a provincial government decides to impose a tax whose incidence affects a certain type of individual, occupation, or activity to a greater degree than is true in other jurisdictions. Within a nation, such a tax can be avoided by means of physically moving to another jurisdiction. This mobility of factors limits the degree to which any provincial government can, in practise, impose a different tax structure or different tax rates.[18] For example, a province that did attempt to increase the progressivity of its tax system, relative to the progressivity of other jurisdictions, would find that some upper-income people would migrate to the lower-tax jurisdictions. Similarly, a higher tax on a certain type of economic activity would give corporations, based on that activity, incentive to move to other jurisdictions. In some cases, such as in sales taxes, residents can avoid a tax that is higher locally than elsewhere by simply making their purchases in the lower-tax jurisdiction. Each provincial government realizes that it cannot raise any tax or combination of taxes very much above the levels elsewhere, and this places a ceiling on tax revenues. Yet each government must raise a total revenue roughly equivalent to its expenditures, and this places a floor on tax revenues. Thus each government is confronted with a downward limit in the extent to which it can offer special tax concessions as well as an upper limit on tax increases. In presenting this view, Bird (1984) refers to the work of Gerard Belanger:

> In this view, insofar as there are benefits to be gained from harmonizing provincial policies, agreement will in fact be reached. If it is not reached, and provinces persist in maintaining inefficient policies, they are unlikely, he argues, to be able to transfer such costs to others through the market. What economic reality dictates usually gets done, and if it does not, the right people, or so he seems to say, will bear the consequences.[19]

Table 4.2
Summary of Differences Between Ontario and Federal Corporate Tax Systems, 1982

1. **Liability for income tax**
   - Residency status
   - non-resident entertainment corporations
2. **Calculation of net income**
   - Capital property
   - 115 per cent depreciable cost incentive
   - Beef cattle stabilization program
   - Interest on loans to non-resident persons
   - Treatment of management fees, rents, royalties, etc.
   - Capital cost allowances
   - Reserves – capital gains
   - Income revenues
   - Foreign taxes
   - Taxable crown corporations
   - Deductible corporate taxes
   - Payments received under the Employment Support Act
   - Foreign tax carry-over on amalgamations
   - Partnerships and their members
3. **Computation of taxable income payable**
   - Political contributions
4. **Calculations of taxable income payable**
   - Small business deduction
   - Foreign tax credit
   - Incentive tax credit for investment
   - Manufacturing and processing profits credit
   - Political donations credit
   - Employment tax credit
5. **Resource Corporations**
   - Resource allowance
   - Depletion allowance
   - Foreign resource property
   - Development expenses

Source: Ontario Economic Council, *A Separate Income Tax for Ontario: An Ontario Economic Council Position Paper* (Toronto: Ontario Economic Council, 1983), p. 38.

There is general agreement that tax differences among provinces can result in location decisions being influenced by tax considerations rather than just economic efficiency considerations. How great an impairment to economic efficiency would be reflected in the provincial choices of tax bases and tax rates? Richard Bird notes that provincial governments must pursue a number of goals besides allocative efficiency and these could legitimately justify considerable tax differences.

> The concept of "harmonization" in most of Canadian literature cited above has been unduly simplified to focus only on allocative efficiency – for the most part in a "first-best" world assuming that governments should and do pursue efficiency with diligence. The real world, however, is full of distortions; real people are concerned with many policy objectives other than efficiency; real governments are made up of real people who do indeed pursue other objectives and, as a working hypothesis, it seems better to assume that Canada is really a "federal" state in more or less the classic sense that the provinces have independent authority in certain respects.[20]

Huggett (1977) emphasizes the need for independent provincial tax initiatives, particularly on the part of economically depressed regions:

> In spite of the almost overwhelming conclusions of the various Royal Commissions and special committees that there should be uniformity with respect to some income taxes in Canada, pressures still exist for separate provincial income tax systems. These pressures are generally the result of different economic objectives.
>
> While there is no doubt that different provincial rules and policies increase the costs of compliance and collection, there is nevertheless something to be said for competition between the provinces for tax resources which, by and large, may be used to attract industry or to develop a more equitable tax system. If the burden of taxation is constant throughout the country, those provinces with natural economic disadvantages will continue to be economically depressed. If, on the other hand, the provinces could offer particular advantages or incentives to industry or special segments of it, a more even distribution of industry and wealth might be achieved.[21]

This discussion is based on the premise that factors of production would in fact respond to the feasible range of tax differentiation. Given the relative importance of other mobility determinants that are not tax related, it is not clear what the precise relationship is between tax differences and the mobility of labour and capital. Consequently, considerable uncertainty remains in this subject.

4. Limitations on Provincial Tax Reforms Imposed by the Federal-Provincial Tax Collection Agreements

The Federal-Provincial Tax Collection Agreements are formal agreements under which most provinces have pledged to accept the federal government's rules and regulations concerning personal and corporate income taxes.[22] In return, the federal government administers and collects taxes on the provinces' behalf. Most provinces have signed such an agreement. In the case of personal income taxes, nine provinces levy a surcharge on the federal taxes owed by their residents. With corporate income taxes all provinces, except Ontario, Quebec, and Alberta, levy their own tax rate against the amount of taxable income as defined by the federal tax provisions. An agreed-upon formula is used to allocate corporate income among provinces, for tax purposes, of corporations operating in more than one province. These agreements significantly limit the scope for tax reform within these provinces.

It is important to remember that the effects of any tax measure may be attained by using an appropriately designed grant or subsidy. The former are off-budget "tax expenditures," while the latter are visible expenditures in the budget. As Thirsk (1984) has noted, the current tax collection agreements only limit how a province is able to achieve certain purposes. He offers an interesting comparison between Quebec's Stock Savings Plan and Ontario's Small Business Development Corporation (SBDC).[23] Under Quebec's Stock Savings Plan, investment tax credits were offered in the Quebec PIT. However, Ontario attained the same end by offering investors in a SBDC a 30 per cent grant towards their investment. As Thirsk (1984) emphasizes, this option of using expenditures, rather than the tax system, applies to many other situations. Furthermore, he remarks that it may be desirable (from the public finance viewpoint) to use budgetary expenditures rather than tax expenditures, as the former are more visible. From an equity point of view, grants are preferable to the deductions offered, for example, in the Quebec Stock Savings Plan. The monetary benefits would be the same for all investors and would not rise with the investor's marginal tax rate.[24]

An important difference between the PIT and CIT arrangements is that each province can choose its own scale of progressivity with the CIT. Basically, each province applies tax rates to taxable income rather than federal tax payable, as with the PIT. However, we should note that the provinces can use the PIT to alter the progressivity of their tax structure. Since the PIT is itself more progressive than other types of taxes, a shift in the share of the PIT in a province's total revenue will shift the progressivity of the overall structure. To increase the overall progressivity of its tax system, provinces need only raise their PIT tax rate on the federal tax payable and lower the rates of a less progressive tax, such as a retail sales tax. With total revenue unchanged, the system will have become more progressive.

In practice, provinces have chosen not to levy multiple tax rates with the CIT, and have chosen instead to apply one rate to small businesses and a higher rate to large businesses. This has proven to be an extremely important provincial freedom within the agreements. It is true that provinces must accept the federal government's definitions and rules as to what qualifies as a small business, as opposed to being a large business. Nevertheless, many provinces have used their freedom to levy a lower rate – and, at times, a rate of zero – on small businesses. As mentioned in Chapter II, it is argued by some that small businesses play a particularly important role in the creation of new job opportunities and in the introduction of new processes and new products. By levying a lower rate against these small businesses, a province might stimulate employment and technological progress.

The discussion of these issues also emphasizes that the provinces are inevitably part of the tax reform process at the federal level. Any changes by the federal government to the personal income tax, corporate income tax, the manufacturers' sales tax, or a new goods and services tax, means that the provinces are also in the midst of tax reform. It is important to understand how federally initiated tax reforms will automatically reform provincial taxes. For each province, independent initiatives will have to be pursued in the context of reforms initiated by the federal government that automatically impact provincial government revenues, and that also impact the after-tax incomes of individuals and corporations resident in that province.

For most provinces, the personal income tax raises between one-third and one-half of their total revenue and for this reason is considered their most important tax. The PIT is also important in that the degree of its progressivity combines with its sizeable revenue to give it a significant impact on income redistribution. Basically, any changes the federal government makes in the definition of taxable income, or in the allowable deductions and exemptions, will, at the same time, involve changes in the provincial tax structures. Presently, there is very little scope for independent provincial initiatives. The provincial initiatives that the federal government has, in fact, permitted deserve comment. These have been summarized, as of 1981, in Table 4.3.

In 1981, the Department of Finance issued three guidelines to which it would adhere in future decisions about permitting new provincial PIT initiatives:

> Three guidelines are followed to determine whether or not a [tax credit] measure will be administered under the Tax Collection Agreements. First, the measure must be able to be administered reasonably effectively. Second, the measure must not significantly erode or have the potential to erode the essential harmony and uniformity of the federal and provincial income tax system. Third, the measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of income tax barriers to normal interprovincial investment flows.[25]

Table 4.3
Special Features of Provincial Personal Income Tax Systems, 1981

Province	Tax Credits	Tax Rebates	Tax Deductions	Surcharges
Newfoundland	—	—	—	—
Prince Edward Island	—	—	—	—
Nova Scotia	—	—	—	—
New Brunswick	political contributions	—	—	Negative surtax of 5.5% of provincial tax otherwise payable
Ontario	property tax, sales tax, political contributions	—	selective	—
Manitoba	property tax, cost of living, political contributions	royalties	selective	—
Saskatchewan	mortgage interest	royalties	selective	Surcharge of 11% on provincial tax in excess of $4,000
Alberta	royalties, renters political contributions	royalties	selective	—
British Columbia	renters, political contributions, cost of living	royalties	selective	Surcharge of 10% on provincial tax in excess of $3,500

Source: Allan J. MacEachen, *Federal-Provincial Fiscal Arrangements in the Eighties* (Ottawa: Department of Finance, 1981).

These guidelines suggest that many conceivable provincial PIT initiatives would be rejected by the federal government. In particular, PIT initiatives to stimulate investment would probably be rejected. For example, provincial measures designed to resemble the Quebec Stock Savings Plan have in fact been rejected.

However, recent developments may indicate a slightly greater willingness on the part of the federal government to administer different types of tax credits for provincial governments. For example, British Columbia instituted a Housing and Employment Bond Tax Credit in 1982. Courchene (1986) sees this as a potentially important precedent. Under the scheme, the interest income on certain bonds issued by the British Columbia government are not taxable under the provincial income tax (although they will be taxed at the federal level). The proceeds from the bonds are loaned, by the provincial government, to eligible individuals, corporations or small businesses, with the largest part of the funds targeted towards housing construction. Courchene sees this as a "remarkable concession by the federal government, since the end result will be to erect barriers to interprovincial flows of enterprises and capital . . . Ottawa probably found it difficult to refuse the proposal in the face of the very high levels of interest rates"[26] then prevailing. A further departure from previous practice has been the agreement by the federal government to collect a small flat tax on net income (as defined on the federal tax return) for the government of Saskatchewan. The agreement was for a short trial period.

Rather than rely upon federal permission on a case-by-case basis, it may be advisable for the provinces to negotiate a modification to the above guidelines. Conceivably, the federal

government might be persuaded to permit a wider range of provincial initiatives than currently exist with the PIT. If such an approach were successful, then the provincial governments might consider investment incentive measures like the Quebec Stock Savings Plan. It is to the modification of these agreements that we now turn.

5. Modifications of the Federal-Provincial Tax Collection Agreements

As indicated in Chapter I, the Ontario Economic Council commissioned a set of studies in 1981 to investigate the implications of Ontario opting out of the federal-provincial collection agreements for the provincial income tax. These studies concerning a separate personal income tax were the basis for an Ontario Economic Council position paper. A basic conclusion of the Council was that substantial reforms could be made to the current agreements without the extreme step of abandoning the agreements. These modifications are presented in Table 4.4, where they are grouped under four headings, together with a summary of the status quo and a summary of the opting out scenarios.

One possible modification would be to institute a federal-provincial committee that would have the power to decide upon all changes in the structure of shared taxes. At present, the federal government has sole power to decide upon these changes and the provinces find out about these changes only through the annual federal budgets. Since federal changes directly affect provincial revenues, it is reasonable that the provinces should have decision-making power in this area of tax reform. Such a committee could consist of Finance Ministers, or it could consist of First Ministers. Since these groups meet regularly, it would be a straightforward matter to include all reform proposals as part of their agenda. No doubt, these deliberations would have to be held "in camera," and the adoption of this modification could entail the promise to maintain confidentiality in these deliberations. Both the personal and the corporate income tax could be included in this new process.

Another modification would be to levy a provincial personal income tax against the taxable income as defined in the federal tax returns. At present, the provinces can only levy their personal income tax against the federal tax payable. Federal tax payable is a figure entered on the federal return after all federal deductions and exemptions have been calculated and the federal tax rates have been applied. Consequently, every federal change to the rate or bracket structure directly impacts provincial revenue. The recommended modification would enable each province to decide upon its own rate and bracket structure and would provide far greater freedom for each province. This modification would become of major importance when proposed federal reforms significantly alter the existing rate and bracket structure.

The provinces could also benefit from greater flexibility in implementing provincial tax credits applicable to provincial tax payable. Such credits could be used to assist a specific income group, to stimulate certain economic activities, or to increase aggregate savings and investment. Once again, this modification would give each province much more power to implement its own policies.

All of these modifications can be instituted within the tax collection agreements. Such an approach is preferential to the opting out alternative for two main reasons: first, the administrative and compliance costs associated with separate tax systems are significant; and, second, operating within the agreements helps preserve an important degree of tax harmonization across the provinces. In the current reform debate, we believe that these

modifications deserve close scrutiny. Federal tax reforms will have a major impact on provincial personal and corporate income taxes. This impact could be much more readily channelled in the provinces' best interests if these modifications were instituted.

Table 4.4
Alternatives to a Separate PIT

1. **Alternative: The Status Quo**

   Characteristics:
   - Centralized federal collection.
   - Minimize administrative and compliance costs.
   - Provincial flexibility limited to applying single tax rate for a restricted set of non-discriminatory tax credits.
   - Provinces required to accept all federal changes in underlying tax structure.
   - Consultation on such changes limited or non-existent.
   - Limited and temporary revenue guarantee.

   Elaboration:
   - Provinces are expressing increased concern over lack of consultation with respect to major and sudden federal changes.
   - Provinces also appear to be constrained in implementing development tax credits. New B.C. tax credits may provide a precedent.

2. **Alternative: A federal-provincial committee on the structure of the shared tax base**

   Characteristics:
   - No changes in the current Tax Collection Agreements.
   - Provinces would have equal status on the committee, reflecting the joint occupancy of the tax field and the constitutional rights of both parties to engage in direct taxation.

   Elaboration:
   - Could run into problems relating to federal budget secrecy in spite of recent initiatives to open up the process.
   - Would not prevent federal action, since there would be plenty of scope for Ottawa to enact changes after the calculation of basic federal tax (e.g., federal tax credits). After some period of notice(say three years) these federal changes would become part of the shared agreement on the part of the provinces.
   - A stronger version of this opinion would require joint federal-provincial agreement prior to all changes in the shared structure. Hence all controversial federal changes would have to be implemented "below the line" as it were.

3. **Alternative: Tax on Base**

   Characteristics:
   - Provinces would tax the federal base instead of piggy-backing on the federal government.
   - Provinces would have control over their own rate and bracket structures.
   - Federal changes in tax rates would no longer affect provincial revenues.
   - Common structure for the base would still obtain.
   - A slight increase in compliance and administrative costs.
   - Would appear to fit easily within the Tax Collection Agreements.

Source: Ontario Economic Council, *A Separate Personal Income Tax for Ontario: An Ontario Economic Council Position Paper* (Toronto: Ontario Economic Council, 1983), pp. 140-141.

This chapter has considered a number of issues that bear upon the appropriate relationship between each province's tax system and those of other Canadian jurisdictions. Authors have written about these issues from various perspectives. The optimal solution is not clear-cut, and it may well change over time as economic circumstances change. Our

position is that provincial governments can, and should, accept responsibility for developing independent tax systems that are geared to the interests of their residents. To some degree, this could be done within the tax collection agreements. However, we believe that some modifications in these agreements would greatly improve a provincial government's ability to carry out tax reform.

Notes

1. Richard A. Musgrave, "Who Should Tax, Where and What?", *Tax Assignment in Federal Countries*, ed. E. Mclure Jr. (Canberra: Australian National University, 1983), pp. 2-19.
2. Wayne R. Thirsk, "Policies Toward Tax Harmonization," in *A Separate Personal Income Tax For Ontario: Background Studies*, ed. David W. Conklin (Toronto: Ontario Economic Council, 1984), pp. 349-350.
3. See for example, M.J. Baskin, "Local Taxes and Product Competition and the Optimal Provision of Public Goods," *Journal of Political Economy* 81 (1973), pp. 203-210.
4. Thirsk, "Policies Toward Tax Harmonization," p. 350.
5. Wayne R. Thirsk, "Tax Harmonization and its Importance in the Canadian Federation," in *Fiscal Dimensions of Canadian Federalism*, ed. Richard Bird (Toronto: Canadian Tax Foundation, 1980), p. 124.
6. C.M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64 (1956), pp. 416-424.
7. Donald R. Huggett, "Tax Base Harmonization," in *Intergovernmental Relations: Issues and Alternatives: 1977* (Toronto: Ontario Economic Council, 1977).
8. *Ibid.*, p. 60.
9. See for example, Richard M. Bird, "Tax Harmonization and Federal Finance: A Perspective on Recent Canadian Discussions," *Canadian Public Policy* 10 (1984), pp. 256-266.
10. See for example, Pierre Fortin, *Provincial Involvement in Regulating the Business Cycle: Justification Scope and Terms*, Economic Council of Canada Discussion Paper, No. 213 (Ottawa: Economic Council of Canada, 1982).
11. For further analysis of the Quebec PIT see Claude E. Forget, "Quebec's Experience with the Personal Income Tax," in *A Separate Personal Income Tax for Ontario: Background Studies*, ed. David W. Conklin (Toronto: Ontario Economic Council, 1984).
12. See for example, Richard M. Bird, *Charging for Public Services: A New Look at an Old Idea*, Canadian Tax Papers, No. 59 (Toronto: Canadian Tax Foundation, 1976).
13. Clarence L. Barber, "Comment" on D.A.L. Auld, "The Scope for Short-Run Fiscal Stabilization Policy Within a Confederation," in *Fiscal Dimensions of Canadian Federalism*, ed. Richard M. Bird (Toronto: Canadian Tax Foundation, 1980), p. 111.
14. Thomas A. Wilson, "Comment" on D.A.L. Auld, "The Scope for Short-Run Fiscal Stabilization Policy Within a Confederation," in *Fiscal Dimensions of Canadian Federalism*, ed. Richard M. Bird (Toronto: Canadian Tax Foundation, 1980), p. 115.
15. Fortin, pp. 32-33.

16. Wilson, p. 116.

17. Further discussion of corporate tax design may be found in Robin Boadway, Neil Bruce, and Jack M. Mintz, "Corporate Taxation in Canada: Toward an Efficient System," in *Tax Policy Options in the 1980s*, eds. Wayne R. Thirsk and John Whalley (Toronto: Canadian Tax Foundation, 1982).

18. See for example, James M. Buchanan and C.J. Goetz, "Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model," *Journal of Public Economics* 1 (1972), pp. 25-43.

19. Bird, "Tax Harmonization and Federal Finances," p. 257.

20. *Ibid.*

21. Huggett, pp. 57-58.

22. See for example, Robin Boadway, "Federal-Provincial Transfers in Canada: A Critical Review of the Existing Arrangements," in *Fiscal Federalism*, research coordinator M. Krasnick, The Collected Research Studies/Royal Commission on the Economic Union and Development Prospects for Canada, Vol. 65 (Toronto: University of Toronto Press, 1986).

23. Thirsk, "Policies Toward Tax Harmonization," p. 358.

24. *Ibid.*

25. Ontario Economic Council, *A Separate Personal Income Tax for Ontario: An Ontario Economic Council Position Paper* (Toronto: Ontario Economic Council, 1983), p. 24.

26. Thomas J. Courchene, "Economic Management and the Division of Powers," in *Federalism and the Economic Union*, research coordinators Mark Krasnick, Kenneth Norrie, and Richard Simeon, The Collected Research Studies/Royal Commission on the Economic Union and Development Prospects for Canada, Vol. 67 (Toronto: University of Toronto Press, 1986), p. 247.

PART II

TAXATION AT THE PROVINCIAL LEVEL

Chapter V

Differences Among Provincial Economic Circumstances and Tax Structures

1. Introduction

Canada's provinces differ considerably in regard to many aspects of their economies. This chapter indicates the nature and extent of these differences, and it discusses the ways in which they may affect provincial decisions about tax reforms. The disparity in provincial economic circumstances described in this chapter has affected provincial tax systems in a number of ways. These provincial differences may, in fact, justify considerable variation in taxes among the provinces.

The fiscal position of each province depends on its fiscal capacity (tax base) relative to its fiscal needs (the funds required to finance public services). This fiscal position will determine the level of tax effort (ratio of tax revenue to tax base) that a jurisdiction will experience. The economic circumstances of a jurisdiction will also influence the tax structure a jurisdiction opts for as well as the relative importance of alternative types of expenditures.

2. Differences Among Provincial Economies

The following tables illustrate the range of differences among provinces as reflected in standard economic indicators. Table 5.1 shows the provincial distribution of personal income and gross domestic product (GDP), and the changes in this distribution between 1966 and 1987. A main feature of the Canadian economy is the concentration of economic activity, with Ontario and Quebec accounting for over 60 per cent of total GDP. Ontario is by far the leader, generating about 40 per cent of total GDP. The recession of 1980-1982 was most noticeable in the data for Ontario and Quebec, with temporary declines in their share of personal income

Table 5.1
Provincial Distribution of Personal Income and Gross Domestic Product, 1966-1987
(select years, as a percentage of the national total)

Province	1966		1971		1980		1983		1987	
	Personal Income	GDP	Personal Income	GDP	Personal Income	GDP	Personal Income	GDP	Personal Income	GDP
Newfoundland	1.5	1.3	1.5	1.4	1.5	1.3	1.6	1.4	1.5	1.3
Prince Edward Island	0.3	0.3	0.3	0.3	0.4	0.3	0.4	0.3	0.4	0.3
Nova Scotia	2.8	2.4	2.8	2.5	2.8	2.2	2.8	2.3	2.8	2.4
New Brunswick	2.1	1.9	2.1	1.9	2.1	1.8	2.1	1.8	2.1	1.9
Quebec	25.8	26.0	24.8	24.8	24.9	22.8	24.2	22.5	24.6	24.0
Ontario	40.5	40.8	41.8	41.9	38.4	37.6	38.7	37.8	40.4	40.9
Manitoba	4.4	4.2	4.3	4.2	3.9	3.7	3.9	3.7	3.9	3.7
Saskatchewan	4.4	4.8	3.4	3.7	3.7	4.4	3.7	4.1	3.5	3.2
Alberta	7.3	8.0	7.5	8.4	9.7	13.5	10.2	14.1	9.3	10.7
British Columbia	10.5	10.2	11.0	10.8	12.3	12.3	12.0	11.7	11.2	11.2
Yukon and NWT	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.4	0.2	0.4
CANADA	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Statistics Canada, *Provincial Economic Accounts, 1976-1987*. Cat. 13-213.

and GDP. Alberta experienced strong gains, particularly in GDP share from about 8 to 14 per cent in the late 1970s and the early 1980s as a result of rising oil prices. However, with recent decreases in oil prices, Alberta's share of GDP has declined somewhat, reaching a level of 10.7 per cent in 1987. There has been relatively little change in the shares held by the other provinces throughout the years. British Columbia maintains its middle range position around 10 to 12 per cent. The remaining six provinces only account for about 14 per cent of total GDP. The share in the Atlantic provinces is the smallest by far. These numbers reflect the differences in size among regional economies and the concentration of economic activities, particularly manufacturing, in central Canada.

Table 5.2 reports yearly percentage growth rates in nominal GDP by provinces over the 1981 to 1987 period. The estimates indicate (a) a wide range of differences in growth rates among provinces on a yearly basis; (b) several changes in provincial ranking year after year; and (c) substantial yearly reductions or increases in growth rates for each province. This illustrates the scope of differences in provincial economic circumstances both at a point in time and over the years.

Table 5.2
Gross Domestic Product at Market Prices,
Percentage Change

Province	1981	1982	1983	1984	1985	1986	1987
Newfoundland	13.4	9.0	8.4	8.4	4.4	6.3	8.1
Prince Edward Island	19.3	4.2	10.8	11.3	2.5	8.7	11.4
Nova Scotia	16.7	15.2	13.8	11.1	8.0	8.2	7.0
New Brunswick	18.6	9.6	14.8	11.8	7.3	9.8	7.3
Atlantic Canada	16.6	11.3	12.7	10.7	6.7	8.3	7.6
Quebec	12.9	5.8	7.0	9.4	7.5	9.8	10.6
Ontario	14.6	4.2	10.7	12.9	8.4	10.4	9.5
Central Canada	14.0	4.8	9.3	11.6	8.1	10.2	9.9
Manitoba	17.6	6.5	6.4	10.8	8.7	5.2	6.2
Saskatchewan	15.6	2.9	3.2	7.6	5.5	-1.8	1.9
Alberta	15.7	5.9	4.7	6.4	7.9	-10.7	3.9
British Columbia	16.9	3.2	4.4	6.2	6.5	3.9	9.0
Yukon	3.8	2.0	-13.8	15.5	5.8	15.9	15.0
Northwest Territories	-3.2	30.2	16.9	18.8	8.1	1.6	2.4
Western Canada	16.1	4.8	4.6	7.1	7.2	-2.6	5.9
CANADA	14.8	5.1	7.9	10.0	7.7	5.9	8.6
GDP implicit price index, Canada	10.8	8.7	5.0	3.1	2.9	2.5	4.3

Source: Statistics Canada, *Provincial Economic Accounts, 1976-1987*. Cat. 13-213.

Table 5.3 compares personal income per capita by province relative to the national average. Column (a) presents personal income per capita relative to the national average excluding transfer income, while column (b) includes transfer income. The following comments relate to column (a). Over the years, personal income per capita has remained the highest in Ontario and the lowest in Newfoundland. Personal income per capita is also above the national average for most years in Alberta, British Columbia, and the Territories. The differential between the highest and the lowest index has decreased somewhat over the 1966-1986 period, but it remains quite substantial. Personal income per capita in the Atlantic provinces has generally been below 75 per cent of the national average. Personal income in Quebec, Manitoba, and Saskatchewan is in the range of 90 per cent of the national average. Column (b) shows the impact of transfer income on personal income per capita by province. The provinces most dependent on transfer income to raise their personal income per capita are Newfoundland, Prince Edward Island, New Brunswick, and to a lesser extent, Nova Scotia, Quebec and Saskatchewan. In 1986, transfer income reduced the gap between richest and poorest provinces from 60 to 42.6 percentage points.

Tables 5.4 to 5.7 present population and income statistics for the provinces and territories for each of 1966, 1980, 1983 and 1986 respectively. These tables indicate the substantial differences among provinces in the absolute level of population and income. The persistence of these differences over time is particularly important.

Table 5.3
Personal Income Per Capita Relative to National Average, 1966-1986 (Canada = 100)

Province	1966		1980		1983		1986	
	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)
Newfoundland	53.4	60.3	55.9	67.1	56.9	69.2	55.5	68.1
P.E.I.	57.9	63.7	60.9	69.0	63.5	71.1	63.0	70.8
Nova Scotia	70.4	73.5	71.2	75.4	75.1	79.3	76.5	81.5
New Brunswick	66.0	69.3	65.3	71.4	68.3	74.6	74.4	75.5
Quebec	92.3	89.7	93.4	96.0	91.0	93.7	92.1	94.6
Ontario	119.1	117.0	108.9	106.4	112.1	108.4	115.5	110.7
Manitoba	90.5	91.3	86.5	86.8	91.3	91.2	92.6	92.7
Saskatchewan	89.3	90.0	85.1	86.4	87.1	89.4	87.6	92.4
Alberta	97.6	98.9	116.9	111.4	110.0	109.5	103.6	104.2
British Columbia	110.2	110.7	114.1	112.5	107.1	107.0	98.0	99.0
Yukon and NWT	94.3	89.5	106.8	102.8	109.0	104.9	104.6	102.0

(a) Excludes transfer income
(b) Includes transfer income

Source: Statistics Canada, "Provincial Income and Expenditure Accounts, 1976-1987 and 1961-1986," *Quarterly Economic Review*. June 1988.

Table 5.4
Population and Income Statistics for the Provinces and Territories 1966

	Population (000's)	GDP (000,000's)	Personal Income (000,000's)	Transfers to Individuals (000,000's)	Personal Income Less Transfers (000,000's)	Per Capita Income Less Transfers
CANADA	20,015	63,908	47,203	3,757	43,446	2,171
NFLD.	493	829	702	130	572	1,160
P.E.I.	109	178	164	27	137	1,257
N.S.	756	1,513	1,313	157	1,156	1,529
N.B.	617	1,222	1,010	126	884	1,433
QUE.	5,781	16,641	12,255	971	11,584	2,004
ONT.	6,961	26,182	19,248	1,251	17,997	2,585
MAN.	963	2,669	2,077	184	1,893	1,966
SASK.	955	2,965	2,031	180	1,851	1,938
ALTA.	1,463	5,016	3,408	308	3,100	2,119
B.C.	1,874	6,538	4,904	420	4,484	2,393
YUK. & N.W.T.	43	155	91	3	88	2,047

Sources: Cat. 91-201, 13-213, Calculated.

Table 5.5
Population and Income Statistics for the Provinces and Territories 1980

	Population (000's)	GDP (000,000's)	Personal Income (000,000's)	Transfers to Individuals (000,000's)	Personal Income Less Transfers (000,000's)	Per Capita Income Less Transfers
CANADA	24,043	309,680	248,890	30,461	218,429	9,085
NFLD.	566	4,095	3,930	1,055	2,875	5,080
P.E.I.	123	846	878	197	681	5,536
N.S.	845	6,292	6,640	1,172	5,468	6,471
N.B.	695	5,019	5,139	1,015	4,124	5,934
QUE.	6,386	72,220	63,473	9,261	54,212	8,489
ONT.	8,570	114,994	94,411	9,630	84,781	9,893
MAN.	1,025	11,188	9,209	1,155	8,054	7,857
SASK.	959	12,400	8,581	1,171	7,410	7,727
ALTA.	2,141	43,148	24,688	2,330	22,358	10,443
B.C.	2,666	38,239	31,057	3,412	27,645	10,369
YUK. & N.W.T	67	1,239	713	63	650	9,701

Sources: Cat. 91-201, 13-213, Calculated.

Table 5.6
Population and Income Statistics for the Provinces and Territories 1983

	Population	GDP	Personal Income	Transfers to Individuals	Personal Income Less Transfers	Per Capita Income Less Transfers
	(000's)	(000,000's)	(000,000's)	(000,000's)	(000,000's)	
CANADA	24,787	403,202	342,836	49,939	292,897	11,816
NFLD.	571	5,485	5,465	1,626	3,839	6,723
P.E.I.	124	1,165	1,221	290	931	7,508
N.S.	857	9,629	9,407	1,805	7,602	8,870
N.B.	703	7,493	7,261	1,587	5,674	8,071
QUE.	6,475	92,274	83,950	14,323	69,627	10,753
ONT.	8,798	151,945	131,947	15,435	116,512	13,243
MAN.	1,046	14,911	13,192	1,904	11,288	10,791
SASK.	989	15,235	12,231	2,051	10,180	10,293
ALTA.	2,339	55,386	35,451	4,759	30,692	13,122
B.C.	2,814	48,151	42,666	6,041	35,625	12,660
YUK. & N.W.T.	72	1,588	1,045	118	927	12,875

Sources: Cat. 91-201, 13-213, Calculated.

Table 5.7
Population and Income Statistics for the Provinces and Territories 1986

	Population	GDP	Personal Income	Transfers to Individuals	Personal Income Less Transfers	Per Capita Income Less Transfers
	(000's)	(000,000's)	(000,000's)	(000,000's)	(000,000's)	
CANADA	25,353	507,808	428,878	62,004	366,874	14,470
NFLD.	568	6,784	6,501	1,939	4,562	8,031
P.E.I.	127	1,470	1,528	370	1,158	9,118
N.S.	873	12,578	11,947	2,289	9,658	11,063
N.B.	710	9,833	9,794	2,151	7,643	10,765
QUE.	6,540	119,439	104,929	17,736	87,193	13,332
ONT.	9,113	204,411	171,253	18,918	152,335	16,716
MAN.	1,071	19,098	16,758	2,410	14,348	13,397
SASK.	1,010	17,195	15,631	2,825	12,806	12,679
ALTA.	2,375	58,268	41,571	5,984	35,587	14,984
B.C.	2,889	56,496	48,338	7,366	40,972	14,182
YUK. & N.W.T.	76	2,236	1,302	151	1,151	15,145

Sources: Cat. 91-201, 13-213, Calculated.

Table 5.8 reports the value of interregional and international trade by region for 1981. The data reflect the openness of each regional economy and the importance of commodity flows between regions. On the export side we see that each region, except British Columbia, exports more to the rest of Canada than to the rest of the world. This is also the case for imports, with Ontario being an exception. The provinces accounting for the largest share of Canadian value-added and gross domestic product are also the ones with a domestic trade surplus. Ontario generates the most exports reflecting its leading position as producer of manufactured products. The table also reflects the importance of the federal government as a purchaser of goods and services in each province. Provinces import on average 31 per cent of the goods and services they purchase, and they export on average 33 per cent of the goods and services they produce. Except for the import ratio of the Atlantic provinces and the export ratio of Alberta, the remaining provinces show remarkably similar patterns of trading activity.

Table 5.9 reports labour force estimates by province. These again reflect considerable differences not only in economic activity, but also in demographics. The participation rates represent the proportion of the population between 15 and 65 years of age that belong in the labour force. The rate is high in Ontario and Alberta, and significantly lower in most Atlantic provinces. Employment, as a percentage of the population, is also highest in Ontario, Alberta, and the Prairies and lowest in Newfoundland, Prince Edward Island, and New Brunswick. The unemployment rate in 1987 varies quite dramatically among provinces from a low of 6.1 per cent in Ontario to a high of 18.6 per cent in Newfoundland. The rates in other Atlantic provinces and in British Columbia are almost double that for Ontario.

The estimates reproduced in Table 5.10 indicate the degree of mobility of the population among provinces for the year 1985-1986. The Territories have considerably higher in- and out-migration rates as a result of a very transient population. However, we can see that most of the provinces, except Quebec and Ontario, experience significant population transfers. The in- and out-migration rates are particularly high for Alberta and Prince Edward Island. The Territories and all provinces except Ontario faced a small net loss as a result of interprovincial migration in 1985-1986. Again, the net out-migration rate is highest for the Territories but net out-migration is also high for Newfoundland and Saskatchewan. The transfers between Ontario, Alberta, British Columbia, and Quebec account for nearly half of total migration. An analysis of interprovincial migration data over the years indicates that there have been some important reversals in the migration balance of many provinces, mainly as a result of significant changes in the economy. However, the basic pattern of migration interaction has not changed very much over recent decades.[1]

Table 5.11 reports the provincial allocation of taxable income of corporations by industry, for 1984. These estimates indicate the industries that predominate in each province and also which provinces account for the major portion of taxable income in each industry group. The provincial concentration of economic activity is again featured in the data. (We should note that since Table 5.11 presents taxable income of corporations, it may not reflect the relative importance of some sectors such as agriculture, retail trade, and services). Ontario, Alberta, and Quebec together account for almost 84 per cent of total taxable income. Ontario's share alone is 40 per cent. The Atlantic provinces account for only 4 per cent. The concentration of manufacturing in central Canada is one of the main features of this table. In Ontario and Quebec, over 40 per cent of taxable income is generated in manufacturing. Manufacturing is also the most important source of taxable income in Nova Scotia, New Brunswick, Manitoba

Table 5.8
Value of Interregional and International Trade by Region, Canada, 1981*
(millions of dollars)

Exports to	East	Que	Ont	Man/Sask	Alta	B.C.	Federal Gov't	Total Exports to ROC	Total Exports to ROW	Total Exports	Exports as a % of Production
Exports from											
East	0.0	1391.0	1469.6	122.6	210.3	88.9	3150.1	6432.5	4284.2	10716.7	29.5
Quebec	3068.0	0.0	13901.7	1729.0	2457.3	1731.9	3646.1	26534.1	16265.9	42800.0	29.5
Ontario	4806.9	16023.2	0.0	4939.6	7806.0	4570.5	8103.7	46250.0	36260.4	82510.4	33.1
West	298.5	1509.5	3318.3	0.0	1917.9	784.7	1731.0	9640.9	6532.3	16173.2	33.3
Alberta	235.9	4474.3	9562.7	3788.3	0.0	5501.4	1217.0	24779.6	15773.3	40552.9	42.6
British Columbia	215.5	1186.5	2123.8	946.4	3109.3	0.0	1768.6	9350.1	13621.8	22971.9	30.8
Total Imports from ROC	8624.8	24665.5	30376.1	11525.9	15500.8	12677.4	19616.5				
Total Imports from ROW	5402.8	22045.5	47593.7	3892.1	5763.1	8041.0	0.0				
Total Imports	14027.7	46711.0	77969.8	15418.0	21263.8	20718.4	19616.5				
Imports as a % of Consumption	35.4	31.3	31.8	32.3	28.0	28.6					
Net Trade with ROC	-2193.3	1868.6	15873.9	-1885.0	9278.8	-3327.3	-19616.5				
Net Trade with ROW	-1118.6	-5779.6	-11333.3	2640.2	10010.2	5580.8	0.0				

ROC refers to rest of Canada
ROW refers to rest of the world
* Does not include Yukon and Northwest Territories

Source: F. St-Hilaire and J. Whalley, "A Microconsistent Data Set for Canada for Use in a Regional Equilibrium Analysis," The Centre for the Study of International Economic Relations, Working Paper No. 85330, London, Ontario.

Table 5.9
Labour Force Estimates by Province, 1987

Province	Population (15 yrs or over) (in 000s)	Unemployment Rate	Participation Rate	Employment/ Population Ratio
Newfoundland	431	18.6	53.1	43.2
Prince Edward Island	97	13.3	62.8	54.5
Nova Scotia	681	12.5	59.8	52.3
New Brunswick	548	13.2	58.3	50.7
Quebec	5,231	10.3	63.5	56.9
Ontario	7,346	6.1	68.9	64.7
Manitoba	811	7.4	66.4	61.5
Saskatchewan	742	7.3	66.7	61.8
Alberta	1,771	9.6	72.0	65.1
British Columbia	2,288	12.0	65.5	57.6

Source: Statistics Canada, *The Labour Force*, December 1987. Cat. 71-001.

and British Columbia. However, Ontario accounts for 56 per cent of total Canadian taxable income in manufacturing. Quebec's share is about 25 per cent. Provincial concentration is also evident in other industries. Alberta, for example, generates 63.1 per cent of its taxable income in mining (including mineral fuels). Mineral fuels are the major source of taxable income in both Alberta and Saskatchewan. Ontario and Quebec generate over 70 per cent of Canadian taxable income in retail and wholesale trade and Ontario alone accounts for 45 per cent of Canadian taxable income in finance and 48 per cent of taxable income in services.

These tables give an indication of the very different economic circumstances faced in each province. The concentration of the population and of manufacturing activity, the location of natural resources, the distance between regions – all these factors result in a nation made up of significantly disparate sub-economies characterized by distinct economic structures and relatively localized advantages and disadvantages. This explains the pattern of uneven regional growth revealed by economic indicators as well as the fact that each region tends to have very distinct concerns and priorities.

This situation is not a recent development, and it is not likely to change in the near future.

> The regional structure of the Canadian economy, and the income disparities which accompany it, show a high degree of stability over the long run. The broad regional patterns and trends are well-defined. Perhaps the most striking, over seventy-five years, is the consistent weight of the Ontario and Quebec economies and the persistent income disparity between the Atlantic provinces and the rest of Canada. Major shifts occur only under exceptional circumstances, such as the Great Depression and the 1973 oil crisis.[2]

Table 5.10
Interprovincial Migration: Migrants and Rates per 1,000
Canada, Provinces and Territories, 1985-1986

Area	In-migration		Out-migration		Net Migration		Mobility Index	
	Number	Rates (per 1,000)	Number	Rates (per 1,000)	Number	Rates (per 1,000)	Number	Rates (per 1,000)
Canada	375,844	14.8	375,844	14.8	–	–	n/a	n/a
Newfoundland	8,214	14.2	13,078	22.5	-4,846	-8.3	21,292	36.7
Prince Edward Island	3,539	27.7	3,777	29.6	-238	-1.9	7,316	57.3
Nova Scotia	20,697	23.5	22,241	25.2	-1,544	-1.7	42,938	48.7
New Brunswick	15,506	21.5	18,527	25.7	-3,021	-4.2	34,033	47.2
Quebec	33,244	5.0	36,659	5.6	-3,415	-0.6	69,903	10.6
Ontario	109,561	12.0	75,705	8.3	33,856	3.7	185,266	20.3
Manitoba	22,278	20.7	24,471	22.8	-2,193	-2.1	46,749	43.5
Saskatchewan	21,349	20.9	29,177	28.6	-7,828	-7.7	50,526	49.5
Alberta	75,575	31.8	77,055	32.5	-1,480	-0.7	152,630	64.3
British Columbia	60,267	20.8	67,924	23.5	-7,657	-2.7	128,191	44.3
Yukon	2,079	90.2	2,555	110.8	-476	-20.6	4,634	201.0
Northwest Territories	13,535	69.4	4,675	91.8	-1,140	-22.4	8,210	161.2

Note: Rates were calculated using the average population between June 1, 1985 and 1986.

Source: Statistics Canada, *Postcensal Annual Estimates of Population by Marital Status, Age, Sex and Components of Growth for Canada, Provinces and Territories*, June 1, 1986. Catalogue 91-210.

Table 5.11
Provincial Allocation of Taxable Income of Corporations by Major Industry Group 1984
(millions of dollars)

Major Industry Group	NFLD		PEI		NS		NB		QUE		ONT		MAN		SASK		ALTA		BC	
	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Agriculture, Forestry & Fishing	1.3	0.4	7.9	9.2	12.6	2.3	14.1	2.7	78.0	1.1	207.4	1.4	26.2	2.9	64.9	6.9	80.7	0.9	103.6	3.9
Mining	94.2	25.2	0.05	0.1	46.1	8.2	21.7	4.1	57.0	0.8	265.0	1.8	53.5	5.9	265.9	28.1	5772.6	63.1	357.8	13.4
Manufacturing	59.8	16.0	14.4	16.6	172.6	30.9	198.3	37.9	3043.8	41.2	6831.5	45.3	275.8	30.3	148.8	15.7	848.5	9.3	556.6	20.8
Construction	13.6	3.7	2.9	3.4	28.2	5.1	28.9	5.5	383.8	5.2	570.8	3.8	30.7	3.4	58.4	6.2	189.4	2.1	116.9	4.4
Transportation, Communications and other Utilities	98.6	26.4	17.5	20.2	66.8	12.0	79.4	15.2	799.6	10.8	1254.2	8.3	86.6	9.5	97.0	10.2	870.0	9.5	379.5	14.9
Wholesale Trade	23.0	6.2	3.9	4.5	51.3	9.2	40.5	7.7	847.1	11.5	1372.0	9.1	98.3	10.7	87.5	9.2	303.4	3.3	256.5	9.6
Retail Trade	27.9	7.5	10.1	11.6	69.0	12.4	59.8	11.4	638.9	8.7	1029.1	6.8	77.9	8.5	74.8	7.9	191.6	2.1	165.1	6.2
Finance	37.8	10.1	24.8	28.7	64.8	11.6	41.7	8.0	876.2	11.9	2011.1	13.3	185.2	20.3	85.4	9.0	460.7	5.0	451.7	16.9
Services	17.0	4.6	4.8	5.6	46.8	8.4	39.5	7.5	661.9	9.0	1532.7	10.2	77.4	8.5	64.2	6.8	436.8	4.8	265.7	9.9
Total All Industries	373.3	100.	86.4	100.	558.2	100.	523.9	100.	7386.4	100.	15073.8	100.	911.6	100.	946.9	100.	9153.9	100.	2671.4	100.
As a Per Cent of Total Taxable Income	0.99		0.23		1.48		1.39		19.60		40.00		2.42		2.51		24.30		7.09	

Source: Statistics Canada, *Corporation Taxation Statistics*. Cat. 61-208.

3. Tax Capacity and Tax Effort

Table 5.12 reports some estimates of tax capacity and tax effort by province, over the years 1981-1983. These terms have been defined by Richard Musgrave as follows:

> **Capacity** A first approximation to fiscal capacity is given by per capita income. This figure provides a comprehensive measure of ability to pay but does not allow for the fact that non-income taxes also play an important role in provincial tax structures or for the non-existence of income taxes at the local level. Retail sales and assessed property value might be preferable indicators in this respect, or capacity might be measured by combining the various bases with appropriate weights. The latter is done by applying a "standard tax structure." This involves (1) determination of the average tax rate which provinces as a whole apply to the major tax bases, and (2) application of this average rate to the tax bases of a particular province. Capacity is then measured in terms of the per capita yield of that tax structure.
>
> **Effort** The simplest measure of tax effort is given by the ratio of revenue to some broad index of tax base such as GDP. This is shown in [Table 5.12] column III, while column IV shows the ratio of actual yield to that obtained if national average rates were applied. We find that effort measures vary less widely than do capacity measures. Some of the low-income provinces exhibit an above-average ratio, notably Quebec, while others are close to the national average.[3]

Table 5.12
Interprovincial Differentials in Tax Capacity and Effort, 1981-1983

	Capacity Measures		Effort Measures	
Province	Per Capita GDP as Percentage of Average (I)	Taxable Capacity as Percentage of Average (II)	Ratio of Tax Revenue to GDP as Percentage of Average Rates (III)	Actual Own-Source Revenue as Percentage of Standard (IV)
Newfoundland	75	59	84	102
Prince Edward Island	77	55	75	99
Nova Scotia	87	66	78	84
New Brunswick	82	66	83	84
Quebec	86	78	135	121
Ontario	137	94	72	100
Manitoba	89	79	101	97
Saskatchewan	102	112	88	104
Alberta	159	217	61	79
British Columbia	102	111	105	102

Notes: Columns I and III are for 1983; columns II and IV are for 1981-1982.

Source: Richard Musgrave et al., *Public Finance in Theory and Practice* (McGraw-Hill Ryerson, Ltd., 1987), p. 493.

Column I in Table 5.12 shows provincial per capita GDP as a percentage of national average per capita GDP and column II reports the per capita yield of an average tax structure in any one province relative to the yield of that structure imposed in a hypothetical average-base province. The first measure ranges from a low of 75 in Newfoundland to a high of 159 in Alberta while the second measure yields an even wider range of 55 in Prince Edward Island to 217 in Alberta. The effort measures vary to a lesser degree than the capacity measures do. The first measure (column 3) consists of the ratio of tax revenue to GDP relative to the average rate. This measure indicates a considerably lower tax effort in Alberta, a considerably higher tax effort in Quebec, and an above average effort in Manitoba and British Columbia. The second index (column 4) shows the ratio of actual tax yield to that obtained if national average tax rates were applied. The range of tax effort is not as wide with this index. Alberta's ratio is again the lowest and Quebec's is the highest. Most provinces are closer to the average than the first index suggests. This table illustrates the effect of disparate economic circumstances on tax capacity and tax effort in the Canadian provinces. We find that these also influence the structure of provincial tax systems.

4. Differences in Reliance on Alternative Taxes

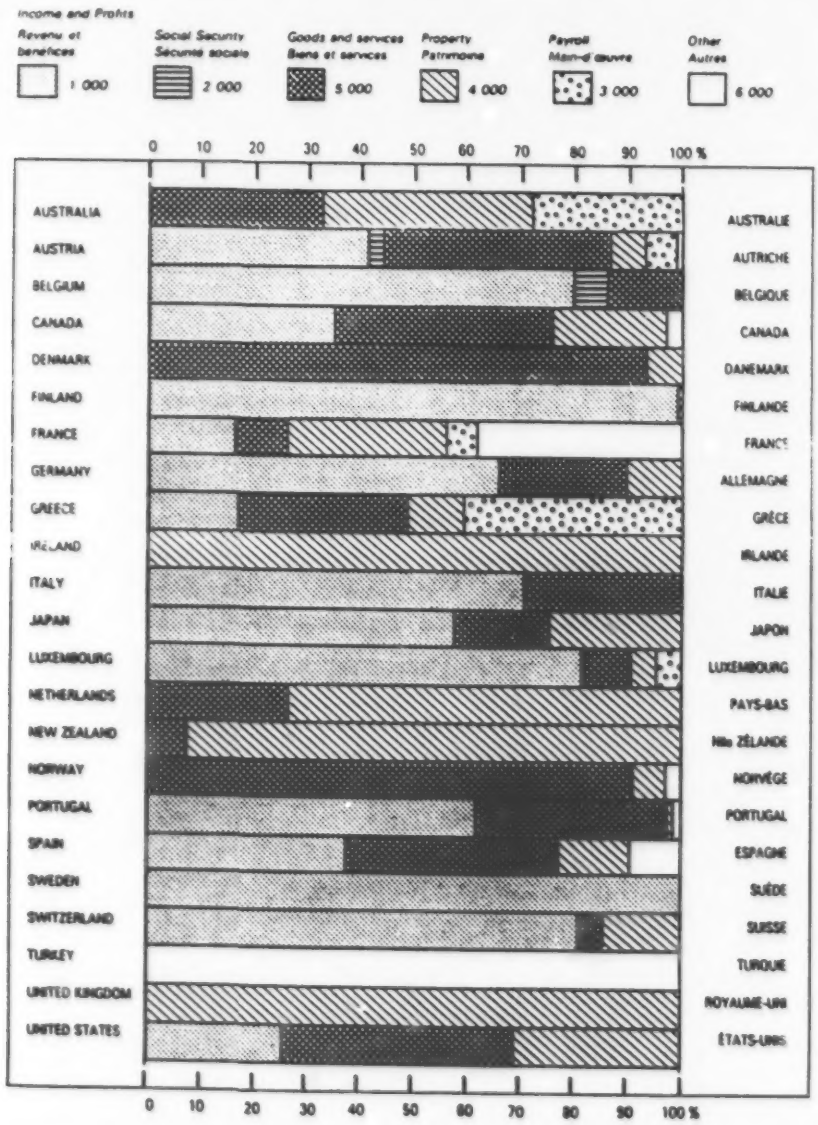
The composition of state and local government tax receipts in OECD countries (1984) is shown in Table 5.13. There is a great deal of variety in the way these levels of government raise tax revenues. In Canada, as in the United States and Japan, state and local governments raise most of their tax revenue using income, sales and excise, and property taxes. By contrast, in some countries there is complete (or almost complete) reliance on a single source of tax revenue, such as property taxes in the United Kingdom, New Zealand, the Netherlands, Ireland, and income taxes in Switzerland, Sweden, Luxembourg, Finland and Belgium.

Tables 5.14 and 5.15 indicate the share of total revenue obtained from each type of tax in each Canadian province. Table 5.14 presents this data for 1970-1971, and Table 5.15 for 1985-86. These tables indicate that each Canadian province does have the power to alter the share of its total revenue obtained from each type of tax. Provincial reliance on particular taxes has varied greatly among provinces. And for several provinces, it has varied greatly over the twelve years being considered here.

For example, the share of total revenue obtained from the personal income tax has varied from a low of 4.6 per cent in Prince Edward Island in 1970-71 to a high of 27.0 per cent in Quebec in 1985-86. The share of total revenue obtained from retail sales taxes (including tobacco) varies from a low of 0.7 per cent in Alberta in 1985-86 to a high of 19.3 per cent in Ontario in 1985-1986.

Increased reliance on the PIT has occurred everywhere, with the exception of Alberta. A substantial variation across provinces still remains: Quebec and Ontario rely heavily on the PIT; the Atlantic provinces rely on it the least. The CIT has increased in importance in New Brunswick, and decreased in Ontario, although at the national level there has not been much change. (There is a natural variance from year to year in the relative importance of the various taxes, so only large changes should be viewed as representing trend movements).

Table 5.13
The composition of state and local government tax receipts



Note: This refers to only those taxes which are classified as state and local government taxes and excludes transfers from central governments.

Source: OECD, *Revenue Statistics of OECD Member Countries*, 1984.

Table 5.14
Sources of Total Gross General Provincial Revenue, Fiscal Year, 1970-1971
(% of total revenue, including transfers from other levels of government)

Sources	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
Personal Income Tax	6.9	4.6	9.7	9.8	24.4	18.1	19.3	12.9	16.1	17.6	18.5
Corporation Income	2.7	1.3	2.6	2.1	4.6	9.1	5.8	3.4	5.4	5.8	6.2
Sales*	12.3	11.1	14.8	15.5	18.7	15.8	13.8	13.0	1.3	16.0	15.2
Motive Fuel	6.2	7.0	8.6	7.1	7.9	8.3	7.8	9.1	7.9	6.2	7.9
Hospitalization Insurance and Medicine Premiums	–	–	–	–	0.8	12.4	5.1	3.4	4.8	5.9	6.1
Succession Duties	–	–	–	–	1.2	1.5	–	–	–	1.4	1.0
Other Tax Revenue**	0.6	0.2	0.4	0.4	1.9	0.5	0.9	0.6	0.8	0.5	0.9
Permits, Privileges, Licences	3.8	2.2	3.4	4.6	6.1	6.3	4.7	10.8	29.8	16.5	8.9
Other Own-Source Revenue***	5.7	12.1	13.3	13.1	5.2	10.9	9.6	18.3	10.5	12.6	9.7
Total Unconditional Transfers	29.1	27.9	21.4	20.4	20.2	0.8	8.4	8.1	1.8	0.1	9.1
Total Conditional Transfers	33.2	33.6	25.6	26.9	9.0	16.5	23.7	20.4	21.6	17.5	1.5

* Provinces differ in the diversion of property tax revenue between provincial and municipal government
** including tobacco
*** including corporation (non-income) – except Ontario
Note: Property tax is included in "other own-source" revenue because of difficulties of interprovincial comparisons due to differing roles of municipal taxation.

Source: Calculations from *Provincial and Municipal Finances, 1970-71* (Toronto: Canadian Tax Foundation, 1972), p. 26.

Table 5.15
Sources of Total Gross General Provincial Revenue, Fiscal Year, 1985-1986
(% of total revenue, including transfers from other levels of government)

Sources	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
Personal Income Tax	11.8	11.5	19.1	14.6	27.0	25.7	17.4	16.6	11.3	19.9	21.7
Corporation Income	2.6	1.7	2.9	3.1	1.6	7.0	3.3	3.4	4.9	3.1	4.0
Sales**	17.4	16.2	17.0	17.3	12.3	19.3	12.7	11.5	0.7	15.9	13.3
Motive Fuel	3.1	3.4	4.3	4.1	3.5	4.1	4.4	0.8	0.03	4.2	3.2
Health Insurance Premiums and Taxes	–	–	–	–	5.1	5.6	–	–	1.4	3.3	3.7
Social Insurance levies*	1.4	1.0	1.2	1.7	2.5	3.5	1.1	1.9	1.8	4.6	2.7
Other Tax Revenue	1.0	0.7	0.7	0.6	3.8	2.8	5.6	3.3	0.8	1.8	2.7
Permits, Privileges, Licences	2.7	1.6	1.6	1.4	2.8	2.7	1.1	1.7	0.9	2.2	2.2
Natural Resource Revenues	1.4	0.3	0.6	0.9	0.4	0.8	1.8	18.2	38.5	7.1	7.3
Liquor Board Profits	1.7	2.1	3.6	2.5	1.2	2.2	3.4	2.2	2.2	3.1	2.1
Return on Investments	7.4	8.5	6.8	4.5	9.6	6.7	11.5	18.8	23.0	8.3	10.7
Sales of Goods and Services	2.7	3.1	3.7	1.3	1.7	2.0	5.0	3.6	1.3	2.9	2.2
Other Own-Source Revenue***	0.5	3.9	0.2	4.2	7.3	1.0	5.6	0.6	3.2	6.3	3.9
Total Unconditional Transfers	29.2	29.4	20.7	23.7	9.1	0.6	12.7	0.7	1.5	0.3	6.2
Total Conditional Transfers****	17.3	16.9	17.9	19.9	12.2	15.8	14.3	16.8	8.5	17.0	14.0

* current and capital income combined
** including tobacco and alcoholic beverages excise taxes
*** includes contributions to pension plans – including the Quebec Pension Plan
**** includes transfers from municipal governments
Note: Property tax is included in "other own-source" revenue because of difficulties of interprovincial comparisons due to differing roles of municipal taxation.

Source: CANSIM MATRICES 2751-63, April 23, 1987.

Table 5.16
Own-Sources of Gross General Provincial Revenue, Fiscal Year, 1970-1971
(per cent)

Sources	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
PIT	18.3	11.9	18.3	18.6	34.5	21.9	28.4	12.0	21.0	21.4	24.9
CIT	7.1	3.4	4.9	4.0	6.5	11.0	8.5	4.8	7.0	7.0	8.3
Sales Tax	32.3	28.8	27.9	29.4	26.4	19.1	20.3	18.2	1.7	19.4	20.4
Motive Fuel	16.4	18.2	16.2	13.5	11.2	10.0	11.5	12.7	10.3	7.5	10.6
Hospital Insurance & Medical Premiums	–	–	–	–	1.1	15.0	7.5	4.8	6.3	7.2	8.2
Succession Duties	–	–	–	–	1.7	1.8	–	–	–	1.7	1.3
Other Tax Revenues	1.6	0.5	0.8	0.8	2.7	0.6	1.3	0.8	1.0	0.6	1.2
Permits, Privileges, Licences	10.1	5.7	6.4	8.7	8.6	7.6	6.9	15.1	38.9	20.0	12.0
Other Own-Source Non-Tax Revenue*	14.3	31.4	25.1	24.8	7.3	13.3	14.1	25.6	13.7	15.3	13.0

* Property tax is included in "other own-source" revenue because of difficulties of interprovincial comparisons due to differing roles of municipal taxation.

Source: Calculations from *Provincial and Municipal Finances, 1970-71* (Toronto: Canadian Tax Foundation, 1972), p. 26.

Table 5.17
Own-Sources of Gross General Provincial Revenue, Fiscal Year, 1985-1986
(per cent)

Sources	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
PIT	22.1	21.4	31.1	25.9	34.3	30.7	23.8	20.1	12.6	24.1	27.2
CIT	4.9	3.2	4.7	5.5	2.0	8.4	4.5	4.1	5.4	3.7	5.0
Sales Tax	32.5	30.2	27.7	30.7	15.6	23.1	17.4	13.9	0.8	19.2	16.7
Motive Fuel	5.6	6.3	7.0	7.3	4.4	4.9	6.0	1.0	0.03	5.1	4.0
Hospital Insurance & Medical Premiums	–	–	–	–	6.5	6.7	–	–	1.6	4.0	4.6
Social Insurance Levies	2.6	1.9	2.0	3.0	3.2	4.2	1.5	2.3	0.2	5.6	3.4
Other Tax Revenues	1.9	1.3	1.1	1.1	4.8	3.3	7.7	4.0	0.9	2.2	3.4
Permits, Privileges, Licences	5.0	3.0	2.6	2.5	3.6	3.2	1.5	2.1	1.0	2.7	2.8
Natural Resource Revenues	2.6	0.6	1.0	1.6	0.5	1.0	2.5	22.1	42.8	8.6	9.1
Liquor Board Profits	3.2	3.9	5.9	4.4	1.5	2.6	4.7	2.7	2.4	3.7	2.6
Return on Investments	13.8	15.8	11.1	8.0	12.2	8.0	15.8	22.8	25.6	10.0	13.4
Sales of Goods and Services	5.0	5.8	6.0	2.3	2.2	2.4	6.8	4.4	1.4	3.5	3.4
Other Own-Source Revenue*	0.9	7.3	0.4	7.5	9.3	1.2	7.7	0.7	3.5	7.7	4.9

* Property tax is included in "other own-source" revenue because of difficulties of interprovincial comparisons due to differing roles of municipal taxation.

Source: CANSIM MATRICES 2751-63, April 23, 1987.

The importance of taxes on motive fuels has fallen everywhere, especially in Saskatchewan and Alberta. However, these provinces have seen a great increase in revenues from natural resources.[4] The data in these tables also emphasize the heavy reliance of the Atlantic provinces on federal transfers as a source of provincial government revenues. In 1985-1986, conditional and unconditional federal transfers contributed on average 43.8 per cent of total provincial revenues in these provinces.

Because of the importance of transfers for some provinces, it can be more instructive to focus on own-source revenues when comparing provincial tax mix. Tables 5.16 and 5.17 report the percentage of own-source revenue obtained from each type of tax by province for 1970-71 and 1985-86. On the basis of province-to-province comparisons, it is also interesting to note for example that richer provinces, such as Ontario and British Columbia, rely relatively less on the retail sales tax. In 1985-1986, Ontario obtained 23.1 per cent of own-source revenue from sales tax, and British Columbia obtained 19.2 per cent, while the smaller, less well-off Atlantic provinces relied more on their provincial sales taxes. Prince Edward Island derived 30.2 per cent of its own-source revenue from retail sales tax while Newfoundland and New Brunswick derived 32.5 per cent and 30.7 per cent respectively. This observation is explained by the lower levels of average income in these provinces. This factor limits the amount of revenue that they can derive from the current rate and base structure of the personal income tax, in comparison with other provinces.

For the total of all provinces, the ratio of personal income tax revenue to sales tax revenue is about 2 to 1. Newfoundland, Prince Edward Island, and New Brunswick are the only provinces in which this ratio is less than 1 to 1, that is, more revenue is derived from the sales tax than from the personal income tax. While these aspects of the provincial tax revenue mix are not necessarily inappropriate at present, they are nevertheless a source of some concern in view of the fact that federal tax reform initiatives call for an expanded federal role in indirect taxation. The requirement for provincial adjustment can be expected to be correspondingly greater where provincial retail sales taxes play the largest role. For example, the New Brunswick sales tax provided 30.7 per cent of own-revenue (17.3 per cent of total revenue) in comparison with the average for all provinces of 16.7 per cent (13.3 per cent of total revenue). Many additional considerations must be raised in detailed assessment of these comparative figures, including such fiscal facts as that only four provinces impose a health insurance levy, that many provinces have a relatively small corporate sector, and that only Alberta, and to a lesser extent, Saskatchewan, can rely on natural resources as an important tax base. The last point explains the much lower percentages derived from personal income tax and sales tax in Alberta.

Table 5.18 presents an interprovincial comparison of tax rates as of April 1987. Newfoundland's personal income tax rate of 60 per cent is the highest rate of all provinces in which PIT is collected under the tax collection agreement. This is followed closely by New Brunswick with a rate of 58 per cent. These rates are substantially higher than those of several other provinces, such as Alberta at 46.5 per cent, British Columbia at 51 per cent, and Ontario at 50 per cent. Some provinces do impose surtaxes on these PIT rates, thereby increasing the total revenue that they derive from the PIT. Provincial corporate income tax rates are almost all in the 15 to 17 per cent range. Quebec is the exception here with a much lower rate of 6 per cent. The general small business rates are also quite similar across most provinces. Again Quebec's rate is substantially lower, as is Alberta's.

Table 5.18
Interprovincial Comparison of Selected Taxes – April 1987

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC
1. Personal Income (Per cent of Basic Federal Tax)[a]	60	55	56.5	58	n/a	50	54	50	46.5	51
Flat Tax on Net Income	–	–	–	–	–	–	–	–	–	–
Flat Tax on Taxable Income	–	–	–	–	–	–	–	–	–	–
Surtaxes on Provincial Income Tax (Various Limits, see Footnotes)	–	–	–	–	–	3	20*	12	8	–
2. Corporation Income (Per cent of Taxable Income)[b]										
General Rate/M&P[c,e]	16	15	15	15	5.9	15.5/ 14.5	17	17	15/9	15
Small Business Rate/M&P	10	10	10	9	3.22	10	10	10/0	5/0	11
3. Corporation Capital (Per cent of Taxable Paid-up Capital)[f]										
Non-financial Corporations	–	–	–	–	0.48	0.3	0.3*	0.5	–	–
Trust Companies	2.0	–	1.5	2.0	0.97	0.6	0.9*	1.2	–	2.0
Banks	2.0	–	1.5	2.0	0.97	0.8	3.0	3.0	–	2.0
4. Retail Sales General Rate (%)	12	10	10	11	9	7	7	5	–	6
5. Gasoline[d]										
Per cent of Retail Price	22	20	20	20	n/a	n/a	n/a	–	n/a	20
Cents per litre	9.8	9.0	8.9	7.7	13.65	8.3	8.9	–	5	8.39
6. Diesel Fuel[d]										
Per cent of Retail Price	26	23	21	23	n/a	n/a	n/a	–	n/a	n/a
Cents per litre	12.1	10.8	9.3	8.2	12.45	9.9	9.3	–	5	6.83

Table 5.18 (continued)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC
7. Tobacco[f]										
Per cent of Retail Price	n/a	n/a	n/a	50	n/a	n/a	n/a	n/a	n/a	n/a
Cents per cigarette	4.78	3.50	4.50	4.12	4.52	2.83	4.60	4.08	4.00	3.88
8. Residential Property Taxes ($)[h]										
(1986 Royal Lepage Survey)	899	1,200	1,378	721	1,579	1,398	1,884	1,596	1,169	1,273
9. Insurance Premiums (%)[d]	4	2	3	3	3	3	3	3	3	3
10. Hospital and Health Insurance Premiums (Maximum monthly rates)										
Single	–	–	–	–	–	29.75	–	–	14*	20
Family of 2	–	–	–	–	–	59.50	–	–	28*	37
Family of 3	–	–	–	–	–	59.50	–	–	28*	42
11. Payroll Taxes (%)[g]										
Employers with Payrolls Under $100,000	–	–	–	–	3.22	–	–	–	–	–
$100,000 to $150,000	–	–	–	–	3.22	–	gradu.	–	–	–
Over $150,000	–	–	–	–	–	–	2.25	–	–	–

* Denotes a budget change effective later in the year.

** Tax rate on manufacturing and processing income.

Notes: a. **Personal Income Tax** — Saskatchewan has a 12% surtax on provincial tax in excess of $4,000, plus a 1% flat rate surtax on net income. Saskatchewan also has a tax reduction of $260 for low income individuals. Effective July 1, 1987 Manitoba will impose a 2% flat tax on net income, combined with a tax credit of 5% of personal exemptions for low income individuals. Manitoba currently has a 20% surtax on provincial tax in excess of $2,600. Effective January 1, 1988 this will be replaced by a 2% surtax on net income above $30,000. Ontario has a 3% surtax on Ontario income tax in excess of $5,000. Alberta, Saskatchewan, Manitoba and Ontario also reduce provincial tax payable at low income levels through application of tax reduction or tax credit measures. In Alberta, effective for the 1987 tax year a flat tax of 1% will apply to net income and a surtax of 8% will apply to incomes in excess of $36,000. Quebec levies its own personal income tax and, therefore, the tax is not presented as a percentage of federal tax.

Table 5.18 (continued)

Notes (continued):

b. **Corporate Income Tax** — In British Columbia, a refundable small business employment tax credit of $300 per employee is payable to corporations for their first 2 tax years after March 31, 1985. The general corporate tax rate will be reduced to 14% effective January 1, 1988. The Ontario manufacturing and processing rate also applies to taxable income from mining, farming, logging and fishing operations. Newly incorporated Ontario small businesses are exempt from tax in their first three years of operation as are Quebec small businesses incorporated after May 1, 1986. In Nova Scotia small businesses incorporated after April 18, 1986 receive a tax holiday for their first 2 years of operation. In New Brunswick an effective rate of approximately 5% applies to firms with less than $110,000 of income for the 1986-1988 period, 9% applies to first $200,000 income and 15% on income above $200,000. In Quebec a rate of 13.24% applies to financial institutions or non-active income. The Quebec rates include their surtaxes introduced in their 1986 Budget. In Newfoundland, new small businesses with $200,000 eligible income can apply between April 3, 1987 and April 3, 1989 for a two year tax holiday.

c. **Corporate Capital Tax** — In British Columbia, effective April 1, 1987 the corporation capital tax will apply to all banks and trust companies operating in British Columbia with paid-up capital in excess of $500 million. A new deduction will also be introduced to permit provincial corporate income tax to be offset against corporate capital tax.

d. **Insurance Premiums Tax** — Tax is payable by insurer. In British Columbia, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Nova Scotia, life, sickness and accident insurance premiums are taxed at 2% and all other premiums are taxed at 3%. In Newfoundland (except marine) and Quebec (excluding individual life, sickness and personal injury), insurance premiums are also subject to sales tax. Most provinces levy an additional tax of 1% or less on fire insurance premiums to fund the Office of the Provincial Fire Commissioner.

e. **Gasoline and Motive Fuel Tax** — Tax rates shown are for regular leaded gasoline and diesel fuel. In British Columbia, the tax on diesel fuel is equal to the gasoline tax plus 0.44 cents per litre. In Quebec, the gasoline and diesel tax rate in restricted outlying regions is reduced by 4.8 cents per litre. Five provinces (British Columbia, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland) adjust tax rates periodically, depending on price fluctuations. Manitoba and Ontario set tax rates annually in their budgets. Manitoba's basic tax rate on gasoline is 8.1 cents per litre with a surcharge of 0.8 cents per litre added to leaded gasoline for a total of 8.9 cents per litre.

f. **Tobacco Tax** — In British Columbia, the tax on cigarettes is indexed to reflect changes in the retail price. New Brunswick uses an ad valorem of 50% set rate applied to a determined retail price (exclusive of tax). Other provinces tax cigarettes by amounts which cannot be adjusted without legislative amendment (Nova Scotia has a 50% ad valorem rate on tobacco products other than cigarettes). Tobacco is also subject to retail sales tax in Newfoundland (37 cents per pack) and Ontario (18 cents per pack). Effective May 4, 1987 a retail sales tax of 7% will apply to tobacco products in Manitoba, and the excise tax will be increased to 4.6 per cigarette.

g. **Payroll Tax** — Only Quebec and Manitoba levy payroll taxes and in both cases they are employer paid.

h. **Property Tax** — Property taxes shown are unweighted averages of all urban centres reported in Royal LePage Survey (October 1986). Taxes shown are for urban three bedroom bungalows (1,200 sq. ft.) with one-car garages.

Source: D. Conklin et al., *An Assessment of New Brunswick's Tax System* (Halifax: Institute for Research on Public Policy, 1987), p. 39.

The retail sales tax rates vary quite dramatically across provinces. Aside from Alberta which does not collect sales taxes, the rates range from 5 or 6 per cent in the Western provinces to 10 to 12 per cent in the East. Excise taxes on gasoline, diesel fuel, and tobacco are generally higher in Quebec and Newfoundland than in the other provinces. The property tax is also apparently subject to considerable variation across provinces.

We can see from this analysis that provinces do have leeway in terms of altering the share of total revenue obtained from each type of tax. Hence, in considering reform options, we must carefully examine the impacts of each type of tax. How does each type of tax affect the attainment of a chosen set of objectives? Much of this book deals with this question.

Notes

1. See for example, M. Termote, "The Growth and Redistribution of the Canadian Population," in *Still Living Together: Recent Trends and Future Directions in Canadian Regional Development*, eds. William J. Coffey and Mario Polèse (Montreal: Institute for Research on Public Policy, 1987).

2. William J. Coffey and Mario Polèse, eds., *Still Living Together: Recent Trends and Future Directions in Canadian Regional Development* (Montreal: The Institute for Research on Public Policy, 1987), p. 22.

3. Richard Musgrave et al., *Public Finance in Theory and Practice* (Toronto: McGraw-Hill Ryerson, Ltd., 1987), pp. 493-494.

4. For the 1970-1971 data, most of such revenue was classified under "permits, privileges and licenses."

Chapter VI

The Personal Income Tax

1. Introduction

The personal income tax is a major component of the federal/ provincial tax system, but it can, at most, be incrementally adjusted by the provinces via changes in the provincial rates applied to federal basic tax, or through changes in provincial tax credits. Nevertheless, given the overwhelming importance of the personal income tax, both as a revenue source and as an influence on private sector economic decisions, it is important to look closely at the incidence and potential shifting of this tax in order to reveal its impact on employment, investment, and growth. In addition, the role of personal tax credits for distributional purposes must be explicitly addressed as pertinent to the need to off-set the regressive effect of increased reliance on indirect taxes, or to target relief to specific groups such as senior citizens.

This chapter will also outline specific tax expenditures that either are in force, or have been proposed – in Quebec, Ontario, Saskatchewan, Nova Scotia and Alberta. These tax expenditures have been designed to encourage investment in the corporate sector by means of income tax credits to financial investors; that is, tax relief to purchasers of corporate shares. The intended economic effect is to increase the pool of funds that can be invested and to reduce the corporate cost of capital thereby stimulating real investment. The programs are: (a) The Stock Savings Plan in place in Quebec, Saskatchewan, Alberta, and Nova Scotia; (b) The Employee Share Ownership Plan as proposed in Ontario; and (c) Venture Capital Programs in place in several provinces, including Nova Scotia. The focus of the discussion will be to indicate how much scope is available for the provinces to implement economic growth objectives, within the context of the personal income tax.

2. On Progressivity

The term "progressivity" refers to the degree to which high-income groups pay a larger percentage of their income in taxes, in comparison with low-income groups. With respect to personal income tax, the provinces have a number of policy options available with which to affect the degree of progressivity of this particular tax. Here we shall consider surtaxes, flat taxes, and tax credits. Adjusting the progressivity of the income tax can be done with a view to altering the progressivity of the overall tax structure.

As far as the provincial governments are concerned, the progressivity of the income tax is largely pre-determined by the federal government through the federal definition of the tax base and the progressive structure of federal rates. Under the Federal-Provincial Tax Collection Agreements of the last two decades the Government of Canada has undertaken to collect the personal income taxes of all provinces with the exception of Quebec. The provincial tax is a simple percentage of the federal tax. The calculation is made at the end of the federal form after the federal tax has been determined. Thus, the provinces cannot directly adjust the provincial income tax base and the progressivity of the structure of income taxation, but they may apply a tax rate of any percentage that is deemed appropriate against the federal basic tax. Generally, the provincial taxes tend to be in the range of one-half the federal tax as outlined for 1987 below.

A province can modify its personal income tax by allowing for special tax credits. These can be geared to specific expenditures like home heating costs or mortgage interest payments. Or they can be aimed at designated groups such as senior citizens. Tax credits can also be based solely on income level as a means of relieving the tax burden on low-income families. The possibility of introducing new tax credits deserves consideration as a means of modifying the progressivity of the PIT and, thereby, the progressivity of the overall tax system. Furthermore, special credits can be designed for purposes of economic incentive.

Provincial Personal Income Tax Rates, 1987[1]
(As percent of federal basic tax)

Newfoundland	60.0
Prince Edward Island	55.0
Nova Scotia	56.5
New Brunswick	58.0
Quebec	n/a
Ontario	50.0
Manitoba	54.0
Saskatchewan	50.0
Alberta	46.5
British Columbia	51.0
Yukon	45.0
Northwest Territories	43.0

A province can also modify its PIT by imposing a surtax on top of the taxes collected in accordance with the provincial rates cited above. A surtax can be designed in many different ways so as to achieve varying degrees of progressivity. Several provinces have introduced surtax modifications to their PIT rates. Another PIT modification is to impose a provincial "flat tax" of a stipulated percentage on personal taxable income. By restricting the flat tax to individuals earning more than a certain income level, progressivity can be dramatically altered. Each of these PIT modifications deserves careful consideration in possible changes to provincial tax systems.

PIT Credits

The requirement for uniform legislation on the definition and computation of income and exemptions, for example, has caused provinces to introduce variations to meet their fiscal objectives through tax credits against the finally computed tax. These credits are acceptable by the federal government if they comply with three criteria established in 1981. The general criterion is that the credit should not alter the basic progressivity of the personal income tax. Furthermore, the tax credit must generally be (1) an allowance for other taxes actually paid; (2) granted to all residents of the province, whether taxpayers or not; and (3) of a character that can be administered easily. Occasionally, exceptions have been made to these criteria. Ontario was the first province to enact credits in 1972 and has maintained tax credit programs since that time. The Western provinces also have maintained tax credit programs of varying types and durations, but interest in the Atlantic provinces has been limited. While the federal government has relaxed its conditions somewhat from time to time, it has continued to reject requests for certain types of credits.

Most tax credit measures have been aimed at social rather than economic objectives. For example, Ontario and the Western provinces have introduced credits which exclude low-income groups from taxability, frequently to match the federal exclusion. Another objective pursued by Ontario, Manitoba, Alberta, and British Columbia has been to provide relief of the property tax through credits to both landlords and tenants. This same group of provinces, as well as Nova Scotia and New Brunswick, offer a nonrefundable tax credit for political contributions. All western provinces allow a rebate for taxes paid on natural resource royalties (arising from the federal disallowance of royalties as an income deduction). Ontario once had a temporary home heating assistance credit. Up to 1982, Saskatchewan offered a mortgage interest tax credit, until it was replaced by a program for direct reimbursement of mortgage interest. In cases of credits against personal income tax liability – refundable or nonrefundable – an upper limit on the credit is specified. For example, in Ontario the combined total of property and sales tax credits may not exceed $500.

Credit programs may be tailored to specific groups, such as senior citizens. Ontario has introduced an income tax credit program for low-income and senior citizens. Low-income taxpayers under the age of 65 have been granted a credit calculated under a formula in recognition of property and sales taxes paid (either directly, or indirectly as tenants) and (temporarily) high energy costs. For senior taxpayers these credits are paid irrespective of income and do not form part of the income tax. Thus the Ontario Government provides annual grants of up to $500 per household to offset municipal and school taxes paid by those over 65 years of age who own or rent their homes. This means that, regardless of personal income, the

first $500 of a senior's annual property tax, whether paid directly or through rent, is refunded by the Property Tax Grant.[2]

Saskatchewan has the Senior Citizens' Heritage Program to provide grants to those above 65 years of age. Persons who have been resident in Saskatchewan for at least six months, who have valid Saskatchewan Health Service cards, and who are not nursing home residents may apply annually to the minister for a grant. The amount of the grant depends on the combined annual income of the eligible applicant and spouse. Where the combined income is less than $25,000 the amount of the grant is $700 for a couple and $500 for a single applicant. The amount of the grant diminishes for higher income levels and/or if the applicant resides in public housing. Only one application per year per couple is permitted. The application must be accompanied by (1) evidence that the applicant or spouse has filed or will file a federal income tax return for the year preceding the current year, and the annual income of the applicant or spouse for that period, (2) evidence sufficient to determine whether the applicant resides in public housing, and (3) social insurance numbers. The law is *The Senior Citizens' Heritage Program Act of Saskatchewan*.[3]

Surtaxes

For the purpose of increasing rather than relieving personal income tax, Ontario, Manitoba, Saskatchewan and British Columbia have imposed surtaxes in addition to the basic tax. For example, in Saskatchewan the surtax has been as high as 12 per cent of provincial tax in excess of $4,000. Ontario has imposed both a surtax and a surcharge, the distinction being that a "surtax" is a "temporary surcharge." Effective for 1986 and subsequent tax years a surcharge was imposed of 3 per cent of Ontario tax payable in excess of $5,000, calculated before foreign tax credit, property tax credit and sales tax credit deductions. The "temporariness" of this law is not clear. The surcharge was introduced in 1985 to be applied in 1986 only. Later, it was amended to continue for 1987 and subsequent taxation years.

In British Columbia the provincial surtax has been imposed on high-income taxpayers since taxation year 1981. The surtax is 10 per cent of provincial personal income tax payable in excess of $3,500. This extra tax is calculated on provincial tax payable after allowances for the foreign tax credit and royalty rebate but before any other provincial tax credit is applied. If, for example, a taxpayer having a taxable income of $36,000 would, without this measure, be required to pay $3,830 provincial income tax, the 10 per cent surtax would apply to the amount in excess of $3,500, in this case $330, and the surtax would increase provincial income tax payable by $33.

British Columbia also imposes a Health Care Maintenance Surtax. This surtax was added by the 1984 Budget to offset increased health care expenditures in the province. The percentage is added to the prevailing rate in effect. Finally, a Health Care Maintenance Levy is also provided for in British Columbia and it too is administered by the government of Canada under proposed amendments to the Canada-British Columbia Tax Collection Agreement. The Health Care Maintenance Levy provides for a prescribed amount of increase for the health care levy where one's taxable income exceeds a prescribed amount. This is similar to the personal surtax in that both apply contingently to high-income earners. However, by 1988 no such amount had yet been prescribed nor had the section been proclaimed into force.

Flat Taxes

A flat tax can be calculated as a straightforward percentage of personal taxable income or of net income. It could be designed as a proportional tax, taking the same percentage from everyone's income. In practise, flat taxes have usually been designed to exempt everyone earning less than a stipulated income level. By restricting the flat tax to individuals earning more than the stipulated income level, taxpayers are divided into tax groups. Designed in this way, a flat tax sharply increases progressivity for those near the dividing line. Yet above the stipulated income level the flat tax is a proportional tax, collecting the same percentage of income from the middle-income earners and from the very rich. From this perspective, a flat tax provides one more mechanism for fine-tuning the progressivity of the personal income tax.

Another feature of the flat tax deserves special mention. If it is levied against personal taxable income, it may be calculated before any of the long list of deductions and exemptions permitted by the federal government. This has two important results. First, it prevents tax avoidance by the wealthy who may have utilized various loopholes to reduce their tax burden. Hence, it serves as a minimum tax. This may be desirable for equity reasons in addition to the progressivity feature. Second, since it need not be reduced by deductions and exemptions, it is able to raise a relatively large revenue with a relatively low tax rate.

3. Personal Income Tax Credits for Purposes of Economic Incentive

The federal government has been reluctant to agree to any form of provincial allowance that involves the use of the income tax system to directly stimulate investment. The view of the federal government is that investment incentives are a federal prerogative; decentralization of investment policy linked to the income tax system creates the risk of uncoordinated interference in national investment flows and could lead to destructive interprovincial tax competition.

In 1978-1979 the federal government refused to agree to a proposal for a dividend tax credit limited to companies having their head office in the province of British Columbia. Indeed, a tax credit for dividend income is not given specifically under any provincial legislation. However, in September 1982, the federal government did agree to administer a flat rate tax credit for interest received by British Columbia taxpayers from an issue of provincial government bonds used to finance housing and employment development in the province. The rebate of the provincial tax clearly allowed the provincial government to raise money at a lower interest rate, akin to tax-free state and municipal bonds in the United States. For individuals, the flat rate credit was 13.5 per cent of bond interest received, the flat rate being relatively more helpful for low- and middle-income taxpayers.

With the British Columbia precedent, the federal government signalled a more flexible position on credits than it took when it dismissed similar proposals put forward by Alberta and (on another issue) British Columbia. There is little relevant difference between the accepted British Columbia credit and the rejected proposal of Alberta (1980) for a rental investment tax credit which was similarly limited to Alberta tax payable and designed to ease the flow of funds into the housing market. The British Columbia credit compromises federal criteria for administering tax credits, including the requirement that credits not impair economic harmony. The British Columbia credit is an unequivocal intervention in the capital market for

provincial purposes. The credit also involves a redefinition of taxable income, a rationale for disallowing proposals in the past. In general, whether these changes are isolated occurrences or the start of a new trend for permitted provincial policy of tax-based economic incentives is not clear. It is nevertheless encouraging for the provinces to the extent it increases the options available for tax reforms. The key point is that there is now precedent and increased scope for negotiation with the federal government on the use of credits in the tax system. For instance, Saskatchewan established a Stock Savings Tax Credit in 1986.

Stock Savings Plans

Stock savings plans were in vogue following the remarkable success of the Quebec Stock Savings Plan. These plans are intended to direct private sector equity capital to provincial industry. Plans typically provide partial relief of the personal income liability of taxpayers who purchase the equity of designated corporations. The benefit of such programs includes the expanded business activity which would not otherwise exist without intervention to correct capital market imperfections. The costs of such programs include tax revenue foregone and the direct expense of administration. Proper accounting of the tax revenue foregone must recognize the incremental increase in revenue generated from the expanded tax base of the economy stimulated by the program. Neither the Quebec nor the Saskatchewan experience indicates undue demands on the provincial tax administration.

The Quebec Stock Savings Plan

The Quebec Stock Savings Plan (QSSP) was introduced by the Parti Québécois government in 1979 with the economic objective of stimulating private sector investment in the province, and with the political objective of strengthening and increasing the autonomy of the provincial financial system. The QSSP provided an incentive for citizens of Quebec to purchase new issues of voting stock of Quebec-based corporations by allowing a deduction from income equal to the value of the new shares bought. The QSSP also had a redistributive dimension. It provided an effective means of lowering the taxes for those taxpayers in the upper levels of the steeply progressive personal income tax rate structure while ensuring that the savings were channelled into provincial investments.

In the early days, QSSP issues were limited to well-seasoned corporations, which attracted the bulk of investor funds channelled toward the new plan, with only a few new corporations participating.

The Quebec Stock Savings Plan has had few restrictions. The corporation issuing the eligible common stock must (1) have at least five full-time employees; (2) have a wage bill of which at least 50 per cent is paid to Quebec residents; and (3) have less than 50 per cent of its assets in the form of other corporate shares, bonds, other property claims, or deposits. The taxpayer may withdraw his or her investment from the QSSP after two full years have elapsed without having to bring any extra amounts into income. With respect to the pricing of QSSP issues, they generally enter the market at a price which reflects the tax benefits. However, the premium is less than the full value of the benefits to the extent that investors expect capital losses. Nevertheless, the premium means that firms are getting capital at reduced cost.

Issues Under the Quebec Stock Savings Plan

Year	Number of Issues	Value of Issues (millions)
1979	4	$275.2
1980	3	120.3
1981	6	74.5
1982	4	140.7
1983	22	566.9
1984	25	257.2
1985	57	849.7

An important feature of provincially sponsored stock savings plans such as QSSP, a feature not present in most other incentive and assistance programs, is that benefits do not affect federal tax payable. An incentive operating through the provincial personal income tax system does not affect federal taxes and thus there is no need to have the program prescribed under the federal *Income Tax Act*.

Not all purchases of eligible shares are actually claimed for tax purposes. The fraction depends to a large extent on the level of development of the financial sector of the province. In Quebec in 1979, QSSP deductions for all taxpayers totalled $49 million in comparison to total equity issues of $275 million. This indicates that large portions of the shares are purchased by persons or corporations not eligible to claim the specific tax concessions, including pension plans, corporate buyers, insurance companies, persons with no taxable income, and out-of-province buyers.

If no deduction is generated, there is no effective incentive. Where there is a premium on the new issues, those not eligible for the tax benefit may reduce their purchases. This creates what is known as a "financial clientele effect." Rather than stimulating new investment, the stock savings plan may have the effect of inducing provincial residents with taxable income to switch their portfolios away from out-of-province stocks toward stocks eligible under the plan, while corporations, non-taxable individuals and non-residents do the reverse. The narrower the class of investors able to benefit from the stock savings plan, the more the plan will simply cause portfolio adjustments with small premiums paid for new issues and large rents earned by those who benefit.

At times, certain new QSSP issues have encountered difficulty in the market. Sometimes, they moved slowly, with dealers being forced to carry large inventories of QSSP stock. Although issues of well-known, well-established companies still are sold readily, they do not sell at the high premiums observed in the early days of the plan. With respect to smaller, more obscure equity issues, their premiums are significantly smaller, reflecting a substantially reduced demand.

Corporations recognize the need to channel new issues to those who can benefit. One approach is to establish employee stock purchase plans. The advantages and disadvantages of government encouragement of such arrangements will be discussed later.

Stocks issued under the QSSP have significantly out-performed other equities. From 1982 to 1986 the average annual growth rates for the QSSP stocks have been 36 per cent

versus the annual growth of 13 per cent for the Toronto Stock Exchange Index over the same period. The number of QSSP accounts registered in the province – each investor must have an individual account for tax purposes – grew from 146,000 in 1983 to about 247,000 in 1985. The success of the QSSP in terms of the objectives of provincially targeted equity investment, together with the provincial government's need for revenue, prompted the Quebec government to reduce the scope of the Quebec Stock Savings Plan. In December 1986, the Quebec Finance Department announced a reduction in the permitted deduction from provincial income tax under the plan to a maximum of $5,500 or 10 per cent of a taxpayer's total income, excluding pension and registered retirement savings plan contributions. Prior to the change, an investor could have deducted the lesser of $12,000 or 20 per cent of total revenue, with pension and RRSP contributions subtracted from the total permitted deduction. In addition, as of 1986:

- the 50 per cent deduction (of the cost of QSSP shares) and the ceiling of $1,000 are now applied to companies with total assets of $250 million or more, rather than the previous $1 billion level;
- on subordinate voting shares, individuals will only be allowed to deduct 50 per cent of the cost of the shares to a maximum of $1,000 from the total revenue, unless the issuer is a developing company with under $10 million in assets;
- for companies with less than $10 million in assets, on subordinate shares with at least one-tenth the number of votes allowed by other shares in the same company, investors can deduct 75 per cent of the total cost of the shares.

These measures are intended to reduce the revenue cost of QSSP. The plan is reported to have involved $606 million in tax revenue foregone over the period 1979-1986. In 1987, the reigning in of the QSSP was expected to result in a revenue cost of $80 million, down from $180 million in 1985.

Impressed by the success of the Quebec Stock Savings Plan, other Canadian provinces have introduced similar incentives to increase the equity of local companies. However, clones are difficult to design because no other province has its own income tax as is the case with Quebec. Furthermore, Quebec has a well-developed financial sector that includes the Montreal Stock Exchange, and Quebec has many companies that are large enough to issue stock. Smaller provinces, with fewer such companies, are at a disadvantage in establishing equity investment programs such as QSSP which are based on the issuance of stock by individual corporations.

The Stock Savings Tax Credit Act of Saskatchewan

The Saskatchewan Stock Savings Credit Plan passed into law in June 1986. It provided investors in new shares of eligible companies a 30 per cent tax credit to a maximum of $3,000 per year. Eligible firms had to pay a minimum of 25 per cent of their salaries and wages in the province, they could not have more than $500 million in assets, they had to be Canadian-controlled companies, and they had to be listed on a Canadian stock exchange. The Saskatchewan plan specified a lower creditable share of the issue price of the stock than in Quebec, and Saskatchewan had a lower maximum credit. On the other hand, Saskatchewan in some respects was less demanding on the characteristics of firm-eligibility, with its

minimum 25 per cent salaries/wages restriction *versus* 50 per cent in Quebec, and maximum asset size of $500 million versus $250 million under the 1986 modifications to the Quebec plan.

In Saskatchewan, the Department of Finance reviews applications and issues eligibility certificates to qualifying companies. Eligible investments are newly issued treasury shares of the qualifying corporation. Shares are not eligible if any federal tax credits apply to them. Once the Department of Finance issues the certificate, an investor's share purchases must be deposited in a plan that is administered by a Saskatchewan investment dealer. The investor must maintain shares in the stock savings plan for two complete years following the year of purchase. However, the stocks held in the plan can change. Any unused stock savings credit may be carried forward for seven years.

The Nova Scotia Proposal

In April 1986 the Nova Scotia provincial budget announced that the government would create a stock savings plan for the 1987 taxation year. The scheme would offer a tax credit against provincial personal tax payable and, unlike the Quebec and Saskatchewan programs, Nova Scotia would extend the plan to include private companies.

The objective of the Nova Scotia plan was to provide capital for provincial industry, especially small business. The savings rate in Nova Scotia has traditionally been high, and thus the stock savings plan was intended more to direct savings than to expand them. In terms of structure, Nova Scotia closely followed the Saskatchewan model. In contrast, however, Nova Scotia allowed two rates in the calculation of allowable credit. By extending the coverage of the stock savings plan to include issues of private as well as public corporations, Nova Scotia faces certain problems in administration and maintenance of the integrity of the plan. Nova Scotia has no securities and exchange commission. Including private companies creates the difficulty of ensuring full and reliable disclosure of financial information of such companies in order to protect the interests of investors. One suggested approach to the problem of risk to uninformed investors in private companies is to require an affidavit signed by the investor confirming that he or she has sought professional investor counselling and advice and that thus he or she is satisfied regarding the information pertaining to corporate ownership, finances, growth potential, dividend payout, etc. The requirement of a formal declaration regarding sufficient information effectively shifts the risk of the investment to the investor and exonerates the stock savings plan from being a vehicle of securities that fail.

The Alberta Stock Savings Plan (ASSP)

The ASSP program was refined during the later months of 1985 and made effective February 1, 1986. Its present program includes four objectives:

1. to strengthen the private sector and create jobs by providing expansion capital for new and growing Alberta companies;

2. to attract more Albertans to capital markets, and encourage equity ownership of Alberta companies by Albertans;

3. to encourage diversification of, and investment in, Alberta-based industries; and

4. to strengthen the Alberta Stock Exchange and the Alberta financial environment.

The plan is intended to offer investors reductions in Alberta tax payable. The tax credit is based on the issue price of the stock, with the tax-credit rate determined by the following classification:

Tax-Credit Rate	Classification
30 per cent	Emerging Corporation
15 per cent	Expanding Corporation
10 per cent	Mature Corporation[4]

The investor tax credit is limited to a maximum credit of $3,000 in respect of a particular taxation year. Corporations eligible for the ASSP are classified according to both revenues and assets. The following table describes the system of revenue/asset classification:

	Total Assets			
Gross Revenue	$0-5 million	$5-50 million	$50-500 million	over $500 million
$0-6 million	emerging	emerging	emerging	excluded
$6-20 million	emerging	expanding	expanding	excluded
over $20 million	emerging	expanding	mature	excluded

Source: *ASSP Information Circular*, November 1986.

Note that, unlike the QSSP which was introduced in 1979, all corporations with assets totalling over $500 million are excluded. Thus, corporations such as Alberta Energy Company, NOVA, an Alberta Corporation, and Canadian Utilities will not benefit from the plan. The remaining qualifications of a corporation include the following:

1. It is incorporated in Canada.

2. It has a permanent establishment in Alberta.

3. Together with its associated corporations, it pays at least 25 per cent of its salaries and wages and management fees to Alberta employees.

4. It has no more than 50 per cent of its assets in the form of financial assets such as cash, stocks, bonds, loans.[5]

Clearly, the ASSP is intended to assist small and medium businesses to access the public equity market. In 1986, approximately 82 per cent of Alberta public corporations qualified as emerging corporations, with expanding and mature companies accounting for approximately 10 and 8 per cent of the Alberta market respectively.[6] The ASSP was expected to create $100

million in equity financing during 1986, which represents a very small percentage of the expected $12 billion in total capital invested in the province.[7]

Employee Share Ownership Plans

Special tax concessions have been developed by many governments in order to assist employees to buy shares in the corporation for which they work. These programs hope to stimulate investment in the same manner as the stock savings plans described above. They have an additional objective: to foster closer labour-management cooperation in the effort to improve productivity.

Robert Reich (1983), whose views have been shaped by Japan's experience, has emphasized the importance of new labour-management relationships.[8] The focus of Reich's argument is based on the observed trend towards "flexible-system production." The era of standardized mass production is disappearing in the Western world, largely because the newly industrialized countries are able to adopt standard production techniques at lower wage costs. On the other hand, there has been an increasing demand for commodities that are unique or that have small production runs. In Reich's opinion, such commodities require innovation as well as special skills. All workers must be involved in the development of the product. The traditional corporate command structure cannot respond quickly or appropriately enough to the customers' specialized needs. New patterns of corporate organization are necessary, Reich argues – patterns that foster entrepreneurial attitudes among all workers.

Other advanced nations may be compelled to copy Japan in developing this active involvement by labour in the innovation process. Currently, many Western corporations are attempting to introduce some elements of the Japanese approach and to imbue production workers with more feeling for their company's objectives and success. "Quality circles" require groups of employees to develop new techniques to improve the quality of the product they are manufacturing. The expansion of profit sharing is based on a hope that production workers will be more conscientious and creative so that their firm will benefit.

Ontario introduced a new employee share ownership plan in 1986. Under this plan, the province provided employees of small- and medium-sized Ontario businesses with a 15 per cent tax credit on up to $2,000 of annual stock purchases. These shares must be newly-issued by their employers' corporations. As an inducement for corporations to issue new shares for this program, the province will compensate them for one-third of the cost of setting up the plan to a maximum of $10,000. It is important to be aware of the greater risk that such a program places on the employee. If the corporation suffers economic hardship, the employee will lose in terms of wages and also in terms of the value of his or her investments. If the corporation should cease operations as a result of bankruptcy, the employee may lose both his or her job as well as his or her savings. This perspective emphasizes the need for political judgement in deciding whether to introduce such a program. While an employee share ownership plan will stimulate productivity and growth, nevertheless, it may expose some participants to extreme misfortune.

Quebec's Labour Sponsored Venture Capital Program

The Quebec Labour Sponsored Venture Capital Program was initiated by the creation of a $20 million investment fund from interest free loans of $10 million from each of the federal and Quebec governments. The fund is managed by a Board of Directors drawn from the Quebec labour movement. At least 60 per cent of the fund's holdings must be in Quebec equities. The fund acquires additional financing by selling shares to investors who in turn qualify for a tax break. An individual can receive a credit against Quebec personal income tax equal to 20 per cent of the share purchase cost as well as a 20 per cent credit against federal income tax. The maximum investment on which the full credit applies is $3500. An additional provision allows this investment to be treated as an RRSP if it is held until retirement.

4. Conclusions

Tax "progressivity" refers to the degree to which high-income groups pay a larger percentage of their income in taxes, in comparison with low-income groups. With respect to personal income tax, provinces could introduce credits and/or surtaxes to adjust the degree of progressivity of the PIT. In view of the significant role of the PIT as a revenue source, adjusting the progressivity of the income tax can be done with a view to altering the progressivity of the overall tax structure.

As far as the provinces are concerned, the progressivity of the income tax is largely predetermined by the federal government through the federal definition of the tax base and the progressive structure of federal rates. Under federal-provincial tax collection arrangements of the last two decades the Government of Canada has undertaken to collect personal income taxes for all provinces with the exception of Quebec. However, a province can modify its personal income tax by allowing for special tax credits. These can be geared to specific expenditures like home heating costs or mortgage interest payments. Or they can be aimed at designated groups such as senior citizens. Tax credits can also be based solely on income level as a means of relieving the tax burden on low-income families. The possibility of introducing new tax credits deserves consideration as a means of modifying the progressivity of the PIT and, thereby, the progressivity of the overall tax system. For the purpose of increasing rather than relieving personal income tax, Ontario, Manitoba, Saskatchewan and British Columbia have imposed surtaxes in addition to the basic tax.

As for the various tax expenditures that provinces have implemented to provide economic incentives, the following observations emerge. First, as indicated above, the strong acceptance of the Quebec Stock Savings Plan – a result which has prompted other provinces to emulate the QSSP – is to a large extent attributable to institutional, fiscal, and political factors specific to Quebec which jointly contributed to the private sector acceptance of the plan. Such factors as a provincially-run personal income tax, steeply progressive marginal tax rates on personal income, a well-developed financial sector including a stock exchange, a political initiative to increase the economic and financial autonomy of the province, and a relatively large and diversified corporate sector, all played a part in the success of the QSSP. Furthermore, the QSSP was well-timed. In the era of high inflation and high nominal interest rates, the QSSP was able to assist both individual investors and also corporations wishing to expand. Previously, corporations had been depending heavily on debt finance due to the difficulty in raising equity. Furthermore, the interaction of high nominal interest rates and the

deductibility of interest drove down the after-tax cost of debt. Most of the debt was held by non-taxable financial institutions and thus individuals had little incentive to participate directly in corporate finance. The QSSP provided such an incentive for investors, and it stimulated the issuance of equity.

Second, it is not clear that the ostensible purpose of the policy is in fact what is achieved by the policy in this form, even with the undeniable heavy subscription to the QSSP. Investment incentives that operate through finance may end up for the most part as capitalized tax savings by the holders of the equity issues with little or no associated increase in real investment. To assess this issue, it is convenient to view private industry as having a sequential set of business risks regarding investment: development risk, production risk, management risk, marketing risk, and growth risk. Development and analysis of production to determine feasibility are conceptual and experimental and, in a market economy, are generally financed with equity contributed by those directly involved with the fledgling enterprise. The commitment to establish operations brings with it management risk and marketing risk; venture capital is the principal source of finance for untried undertakings. Finally, the established, but financially constrained, business requires more permanent capital to finance growth; but the risk of this form of investment is relatively low, and so the public is generally willing to provide equity capital. Thus equity induced by a stock savings plan is directed primarily at established firms with a growth potential that would otherwise be constrained by finance. A stock savings plan should not be viewed as substitute for a venture capital program. The question then is whether to introduce a personal tax expenditure to encourage the growth of established firms, in which case a QSSP-type program has some potential merit, or whether the policy objective is to offset the capital market imperfection that hinders the establishment of new and innovative enterprise, in which case the focus should be on a venture capital program, and on new investment tax credits and employment tax credits.

We have discussed the increasing emphasis within many activities on trying to encourage employee involvement in productivity and quality improvements. Tax concessions for employees who purchase shares in the company for which they work are one method of encouraging this involvement. We have described the 1986 Ontario program that introduced this type of tax concession. We have drawn attention to the kind of risk that such a program places on the employee. If the corporation suffers economic hardship, then the employee will lose in terms of wages and also in terms of the value of his or her investments. During an economic recession, the employee could lose both a job and savings. In view of this risk, these advantages and disadvantages should be weighed carefully.

The Quebec approach of offering tax concessions to labour unions in accordance with their purchases of corporate shares may, hopefully, improve management-labour cooperation, while perhaps exposing each employee to less risk of losing both a job and investments. That is, the approach of channelling the concession through union group purchases of shares may permit a diversification of portfolio for the individual. On the other hand, this intermediation by the labour union may separate the employee from his or her personal investment to the degree that the basic incentive purpose may be limited.

Notes

1. As of 15 June 1987, Saskatchewan's budget for 1987-88 had not yet been presented.
2. The details of the program are found in *Topical Tax Reports (Ontario)*, CCH Canadian, paragraph 15-851, 1987, a description of the Ontario Pensioners Property Tax Assistance Act, 1980.
3. See S.S. 1984-85, c.S-46.01, ss.2,5(1); para. 97-352, 97-356. A description is found in *Topical Tax Reports (Saskatchewan)*, CCH Canadian, parag. 10-017a, 1986.
4. *ASSP Information Circular*, November 1986.
5. *Ibid.*
6. *Globe and Mail*, January 8, 1986.
7. *Globe and Mail*, November 15, 1986.
8. Robert Reich, *The Next American Frontier* (New York: Times Books, 1983).

Chapter VII

The Corporate Income Tax

1. Introduction

Although the primary purpose of taxation is to raise revenue, the tax system is also used as an instrument of economic policy. There are numerous possible goals of economic policy, and this chapter will focus on three of them only – the goals of growth, employment and equity. Specifically, this chapter considers the corporate income tax as an instrument in these regards, and it analyzes the potential for the provincial governments to utilize this tax for such policy objectives.

The chapter begins with a brief overview of the corporate income tax in Canada as it presently exists. This is followed by a survey of the direction of corporate income tax reform in North America as enacted recently in the United States and by the federal government of Canada. In the next section there is a general discussion of using the corporate income tax for policy objectives such as growth, employment and equity which is followed by a section that directly addresses possible provincial reforms in this regard. This section also discusses the possibility of increasing provincial revenue through changes in the corporate income tax or by levying a related provincial tax such as a corporation capital tax.

2. The Corporate Income Tax in Canada

The corporate income tax in Canada is the second largest source of revenue for the federal government, but only the fourth largest source for the provinces. The share of total revenue collected through the corporate income tax has declined steadily since the 1950s at both the federal and provincial levels. The provincial corporate income tax is collected by the federal government in all provinces except Alberta, Ontario and Quebec which collect their own.

Participation in the Federal-Provincial Tax Collection Agreements places significant limitations on the flexibility of provincial corporation tax policies. In particular, provinces must adhere to the corporate income tax base as defined by the federal government in terms of taxable income, exemptions and deductions. Provinces are free to set their own rate, although the federal government does set a basic ten percentage point abatement. All provinces set rates in excess of this basic abatement. Provinces can also introduce tax credits and rebates although these are subject to federal approval. With respect to such provincial credits, the federal government tax collection procedures are essentially limited to "checking the arithmetic" and it is up to the province to ensure that the credits are not being abused.

The corporate tax base, as defined by the federal government, while far from being consistent in terms of economic philosophy, does pay lip service, at least, to a number of principles. The first views the corporate income tax as an adjunct to the personal income tax and provides some relief from the double taxation of dividend income by the means of a dividend tax credit. The dividend tax credit in Canada does not, however, fully integrate corporate and personal income because it is set so as to credit the average corporate tax paid per dollar of dividends distributed rather than the corporate tax actually paid by the company issuing the dividend. Thus there is under-integration for tax paying corporations and over-integration for non-taxable corporations. The latter are very important in Canada because of the magnitude of losses carried forward.

A second principle that underlies the corporate income tax in Canada is the accrual principle. The accrual principle requires that capital costs be amortized and deducted over the life of the asset rather than at the time the asset is acquired as under a cash-flow system. Where immediate expensing is allowed, as in the case of some resource-based industries and for R&D capital, it is considered a special incentive. While the corporate tax is levied in principle on an accrual basis, it is badly distorted both by the corporation tax provisions themselves and by the presence of inflation. The provisions presently allow for accelerated depreciation, meaning that in the early years of its life, an asset is written off more rapidly than it would be under the "straight line" or "book" depreciation rates. In addition, there is no attempt to adjust the capital costs for changes in the purchasing power of money over time. Consequently, in the presence of inflation, the accrual system is very imperfect. In fact, the evolution of the corporate income tax system over the 1970-1985 period was largely the result of a series of *ad hoc* changes designed to mitigate the effect of rising inflation on the corporate tax liability.

Third, the corporate income tax has been viewed as an important instrument of industrial policy in Canada, as in many other countries. Noteworthy in this regard are the special rate on manufacturing and processing, the R&D and investment tax credits, special provisions for the resource industries, special rates and credits for slow growth regions and the reduced rate for small business corporations.

The important point is that under the Tax Collection Agreements, most provinces are essentially committed to the federal corporate income tax base as it is presently defined. As such, each province participating in these agreements is also committed to the underlying economic philosophy and policy implications of the tax base. It should be stressed, however, that although provincial flexibility would be greater if these provinces levied their own corporate income tax, there would be a significant increase in administrative and compliance costs for the provinces and for the corporations resident in the provinces. Moreover, it is not clear that the increase in provincial policy flexibility would be substantial. The three

provinces that do collect their own corporate income tax find it necessary to parallel the federal tax base closely in most regards. Therefore it appears certain that in considering the corporate tax policy alternatives available to these provincial governments, certain constraints imposed by the Tax Collection Agreements must be taken as given, although there may be scope for the seven provinces to negotiate some sort of increased flexibility collectively.

In addition to the corporate income tax, several provinces levy a corporate capital tax. Essentially this is an additional form of property tax that is levied on the paid up capital of a resident corporation. The paid up capital is generally taken to be the capital stock plus reserves and surplus plus loans and advances although a simpler base is used for banks, and loan and trust companies in Ontario and Quebec. Only such financial firms are subject to the capital tax in British Columbia, Newfoundland, Nova Scotia and New Brunswick.

An important feature of the capital tax is that it is deductible from the corporate income tax. Thus in a very real sense it diverts corporate income tax revenues from the federal government to the levying province, and the burden on the corporation is less than the revenues collected through the capital tax. Provincial capital tax rates have risen steadily in the last few years, and it is unlikely that this diversion of revenues has gone unnoticed by the Department of Finance in Ottawa.

3. Corporate Tax Policy for Growth, Employment and Equity

The corporate sector includes a very large part of the productive activities in the economy, so it is not surprising that corporate tax policy has been considered important for encouraging growth and employment. The role of the corporate tax in the pursuit of equity is less clear since there is still very little known about the incidence of the corporate income tax. Everything economic theory has to say about this question does suggest that a corporate tax imposed by a small open economy (such as a province, or for that matter, Canada) alone is unlikely to be borne by equity capital owners since such capital is highly mobile geographically and across national borders. As a result, when "the smoke clears" so to speak, increments in corporate tax rates in a province above those prevailing elsewhere are likely to be borne by owners of geographically immobile factors of production like land and existing improvements, or by geographically immobile consumers such as the elderly. Corporation income tax revenues that are generated at tax rates that do not exceed those set elsewhere, however, can be expected to be borne mostly by the shareholders of the corporation, since there is no more advantageous location to which the capital can be shifted. Thus many economists believe that there are few reasons for expecting that higher than average corporate tax rates in a single province would advance the equity goals in that province, while lower than average rates would mostly benefit capital owners and thereby reduce the level of vertical equity. For this reason, this section will focus mainly on the goals of growth and employment although the equity considerations do enter as a constraint when revenues must be raised from other tax sources to finance tax incentives at the corporate level.

Concerning growth and employment, there are two main philosophies regarding the use of the tax system in general and the corporate income tax system in particular for pursuing these goals. The first view is that the tax system should be used directly to encourage and stimulate selected activities with targeted tax reductions, credits, exemptions and tax holidays. The second is that the tax system should be designed so as to provide a stable and

neutral environment that does not interfere with the allocation of resources as determined by market profitability. The federal corporate tax system is consistent with neither philosophy from a purist viewpoint. It does contain, as mentioned above, certain provisions which seek to encourage a broad range of activities but, at the same time, it would be fair to say that it has not been loaded up with a lot of selective provisions. Moreover, the thrust of corporate tax reform at the present time has been toward the second philosophy. An avowed purpose of the 1988 corporate tax reform proposals is to reduce the variance in effective tax rates across different activities and different types of capital, and to increase the importance of market profitability, as opposed to tax considerations, in determining output and investment.

Even if one adopts the neutrality philosophy, certain types of tax incentives can be entertained. In an economy with poorly functioning labour and capital markets, certain tax incentives may be corrective and can increase economic efficiency in the allocation of resources. For example, in view of the structurally high unemployment rate in the Atlantic provinces, policies that encourage and increase job formation may be highly desirable. Jobs are created by individuals and corporations who raise capital, bear risk and undertake ventures with the prospect of a profitable reward. Tax incentives can be provided through lower corporate tax rates, tax credits for employment and/or investment, and increased deductions and allowances. Lower rates increase the after-tax reward while credits and deductions reduce the costs of entrepreneurial endeavours. Corporate tax policy is, of course, but one policy that may be used to increase the supply of jobs through encouraging entrepreneurship.

A difficult problem with tax incentives is that the tax revenues which are lost must, in light of the binding government budget constraints, be made up by taxes elsewhere. Furthermore, lower rates and credits subsidize activities that would have been done anyway, as well as the activities newly encouraged. For the former there are tax revenue losses but no social benefit. For this reason incremental credits and allowances are sometimes used such as the employment tax credit introduced by the federal government in 1978 and the incremental R&D allowance that existed prior to 1983. Such incentives only apply to new employment or investment, so less revenues are lost on expenditures that would have been made anyway. The main problem with incremental incentives is that they complicate compliance and are difficult to enforce. Further, they may actually discourage an activity because they reduce future incentives. In fact it is an incremental aspect that makes investment tax credits preferable to reduced corporate tax rates and increased depreciation rates as a means of encouraging investment, in the eyes of many policy makers. The latter incentives apply to both old and new capital and therefore involve a greater revenue loss for a given level of incentive than do investment tax credits which only apply to new capital. Unfortunately, investment tax credits encourage short-lived investments relative to long-lived investments, and this may not be desirable. While investment credits have this impact, the full expensing of assets or the increase in first year write-offs are neutral across asset lives, and so may be seen as preferable from this perspective.

Incentives for both employment and capital formation often are advocated as job creation policies. In fact, at given levels of production, investment incentives may encourage the substitution of capital for labour and thereby discourage employment, particularly if the capital-producing industries are not located within the domestic economy. However, it is widely believed that the longrun impact of capital incentives is to create jobs by reducing costs and making labour more productive. This requires that output grow as a result of capital

formation and in the process, create jobs. By this argument, investment incentives for job creation would be most effective for industries where the output elasticity of employment is high.

Some economists have argued that employment incentives are more effective at job creation than investment incentives. It is probably the case that, in terms of shortrun impact, this is correct. The difficulty with employment incentives is twofold. First, in the absence of a workable means of making them incremental they have a high revenue cost because wages constitute such a large part of value-added. Second, they may encourage employment at the expense of growth since they provide a disincentive for labour-saving investment. The end product of employment subsidies is more likely to be the creation of lower wage jobs and a stagnant technology.

Both the federal government and all provinces levy a lower corporate tax rate on small Canadian corporations. Also, special incentives have been provided by some provinces, including the two year tax holiday for new small businesses enacted in Ontario in 1987, and the zero rate for small businesses in New Brunswick in 1984. Between January 1, 1986 and December 31, 1988, New Brunswick implemented a special credit that effectively reduced the small business tax rate. For corporations with less than $110,000 in active business income, the tax credit was equal to 44 per cent of New Brunswick's corporate tax otherwise payable at the small business rate to a maximum of $3,960 per year. This effectively reduced the rate to about 5 per cent.

A standard argument for the preferential taxation of small businesses is that such businesses create a significant fraction of the new jobs in the labour market. This observation should be tempered by the knowledge that the turnover rate of employees of small businesses is much higher, so they also are disproportionate in the creation of displaced employees. A more theoretical argument for the preferential taxation of small business is that capital markets are highly imperfect, and small businesses have difficulty raising capital for what may turn out to be profitable ventures. To the extent that tax incentives allow such ventures to proceed, both the tax base and employment are increased. A difficulty with this justification is that the tax preferences actually in place may do little to help the cash flow of small businesses. For example, since small businesses are very reliant on loan financing (the interest rate on which is deductible), the advantage of a low or zero rate on revenues is largely offset by the fact that interest costs are deducted. For this reason, it has been argued that small business would be helped more by allowing it to expense its capital expenditures immediately, at least up to some limit, with a refundable tax on losses created. This would, in effect, engage the government in the partial financing of small business.

Another concern is that very low small business tax rates may allow tax avoidance on personal income by channelling it through a small business corporation. It is important for revenue reasons that this be prevented by integrating the income of small corporate businesses with that of their owners. Under full integration of the PIT and CIT for small business dividends, retained earnings of small businesses would be taxed at a lower combined rate than dividends. Without full integration, the lower rate may not distinguish between income which is reinvested and that which is taken out of the firm. Thus the same preference may be given to the firm whether it is investing and creating new employment (which is what the government seeks to encourage) or not. These arguments also suggest that favouring

small businesses in the form of generous deductions (such as immediate expensing of capital) or investment tax credits is preferable to the provision of reduced tax rates.

From a provincial point of view, it would obviously be desirable to attract larger firms and new industries, particularly those that generate considerable employment. The main strategy for this is to provide a generally hospitable environment for business and industry and advertise that fact. This requires attention to more than just the tax system, and encompasses labour and output market policies as well. The main thing that can be done on the corporate tax side is to avoid raising the provincial rate to a level which would brand the province in question as a high corporate tax province. Certainly it would be undesirable for corporate tax rates in provinces that are less industrialized to exceed those in the major industrial provinces like Ontario. Likewise, there would be no advantage in lowering the basic rate below the 10 percentage point abatement allowed by the federal government.

There are numerous arguments for special tax preferences for R&D spending by firms. The usual argument is that such spending has major beneficial spillover effects on other firms, and there is considerable evidence that this is in fact the case. Also, it is hoped that incentives to R&D spending will attract high employment and clean industry into the province. Two cautions must be stated. First, from a provincial viewpoint, the spillover argument only justifies provincial incentives to the extent that those spillovers are concentrated in the province. Second, tax incentives to R&D are widespread and it is unreasonable to expect that poorer provinces can win a bidding war with the richer provinces in attracting "high-tech" industry by favourable tax treatment. This is not to say that there is no scope for provincial incentives in this regard. However, provincial incentives should be provided only for R&D spending carried out within the given province. Moreover, qualifying expenditures should be those which are more of the application type rather than the discovery type, since these are more likely to provide immediate advantages within the province.

Before considering some specific provincial corporate tax reforms, a few comments must be made about the choice between incentives offered to firms through the tax system *versus* grants to firms. Any tax incentive can be duplicated by government through firm grants, since the full tax revenues could first be collected and then distributed as grants. There are two possible advantages to the grant process. First, the use of grants allows greater discretion on the part of government as to which firms receive the incentives and the purposes for which the funds are put. Second, the grant could be used to achieve exactly the same result as a tax incentive, if the tax incentive is not possible politically. This may occur in the provincial context if the federal government were to reject the tax incentive proposed by the province. According to experiences in other jurisdictions, the main disadvantages in using grants are that they are costly to administer particularly if they are to be made very selective, they may be distributed to achieve political ends rather than economic, and they divert the energies of firms away from productive activities to "grantmanship." For general incentives such as those proposed in this document, the tax system appears to be the most cost effective way of delivering the incentive. Grants could be used, however, if the proposed incentives did not obtain federal approval.

4. Conclusions

In light of the present discussion, certain observations emerge with respect to provincial corporate tax reform options. Reductions in provincial tax rates may attract new industries and signal that the province is a good place to invest. However, such reductions would be costly in terms of revenues forgone and, as mentioned earlier, reductions in corporate tax rates reduce taxes largely on capital that is already in place. In short, it is not a cost effective way of encouraging new investment and employment.

Provinces considering the implementation of a corporate capital tax should assess the pros and cons of such an approach. In the context of the Canadian economy as a whole, the corporate capital tax is a tax which is probably a bad tax, yet is advantageous to the individual provinces since it diverts tax revenue from the federal government and therefore raises more provincial revenue than the burden placed on the corporation. Until it is no longer deductible from the corporate income tax, it is an inexpensive source of revenue for the province. Its main disadvantage from a provincial point of view is that it must be administered by the province and also imposes compliance costs on the corporations. In addition, it may impose a competitive disadvantage on the province in attracting industry if its neighbours do not levy such a tax. The compliance disadvantage can be mitigated by exempting small business corporations or by levying a flat tax on them. Also, the corporate capital tax may be a good source of revenue to finance investment or employment incentives.

There is now considerable evidence suggesting that tax credits for new investments are successful in increasing capital formation and employment, although the amount of investment created may be less than the tax revenues lost. There is a strong case for using a generous tax credit, perhaps refundable, for investment by small businesses instead of a preferential tax rate. The tax credit can be used to improve the cash flow of small businesses while the disadvantages of the higher rate are not as severe on small businesses as might be expected because interest on the firm's debt and the depreciation allowance are deducted at a higher rate. It is necessary to use a tax credit, rather than immediate expensing or a 150 per cent allowance, because it can be administered within the Tax Collection Agreements.

There is some case for a provincial credit for R&D spending undertaken within the province, especially if R&D is directed towards applications that would have an immediate commercial impact within the province. However, it is likely that the R&D tax credit will survive corporate tax reform at the federal level whereas tax incentives for conventional investment will not. For this reason it may be desirable to focus what little revenue room there is for tax incentives at the provincial level on conventional capital incentives. Furthermore, R&D incentives are plagued with the problem of the redefinition of expenditures as R&D, solely to get the tax advantage. This implies a revenue loss without any benefits unless the province has the resources to monitor such redefinition carefully.

Notes

1. For example, the R&D allowance was based on increments above past levels of R&D spending by the firm. A firm which is currently spending less than past amounts but expects to spend more in the future is discouraged from spending more currently since it raises the base for calculating the increment. This would reduce future allowances without any current benefit.

2. The output elasticity of employment refers to the percentage increase in employment for a given percentage increase in output. As a first approximation this might be measured by labour's share in value-added. Thus, investment incentives create the most employment when given to industries with high labour shares in value-added.

Chapter VIII

Sales Taxes

1. Introduction

Sales taxes are a significant source of tax revenue for provincial governments. Based on 1985-1988 budget estimates, sales taxes were the most important source of non-transfer revenues in New Brunswick, Newfoundland, and Prince Edward Island. In all other provinces, except Alberta, sales taxes were the second most important source of revenue after the personal income tax. Because of its relative importance as a source of revenue and because of its potentially significant impact, the retail sales tax (RST) merits special consideration. This chapter examines provincial retail sales taxes in the context of the general principles of indirect taxation. The issues of particular interest are the relative importance of RST as a source of revenue, and the choices of rate level, exemptions and exclusions from the base.

An additional issue concerns the second phase of the federal tax reform initiated in the 1987 White Paper. With its 1989 budget, the federal government has clearly indicated its intention to impose a multi-stage sales tax. The government considered three alternatives: (1) a National Sales Tax that would replace both the present federal sales tax and provincial retail sales taxes with one uniform system; (2) a federal-only goods and services tax; and (3) a federal-only value-added tax. Each of these alternatives would be applicable to a broad base of goods and services and would be imposed on the value added at each stage in the production-marketing chain. This tax is expected to generate more revenue than the current federal sales tax and may be seen as a means of reducing the personal and corporate income tax rates. Regardless of which variant is chosen, the implementation of a multi-stage sales tax will have significant implications for the provinces. The definition of a value-added tax base is essentially equivalent to that of the RST so that the federal government can be seen as moving into a tax field previously occupied by the provinces. Also because current RST rates apply to

the value of goods gross of the manufacturers' sales tax (MST), replacing the latter with a broader ranging sales tax at a lower rate will immediately affect provincial sales tax revenues.

In the 1987 White Paper on Tax Reform, the federal government indicated its preference for the National Sales Tax (NST) alternative, although it also stated its intention to pursue one of the other approaches if an agreement with the provinces could not be reached. In its 1989 budget, the federal government indicated that provincial negotiations had not been successful to date, and so it planned to impose a federal-only goods and services tax. Indications are that the multi-stage sales tax base will be much broader than current provincial RST bases, and also that such a tax will be more effective in avoiding the tax cascading which occurs through the taxation of business inputs and capital goods under the RST. On the other hand, provinces who opt for a sales tax sharing agreement with the federal government could lose considerable flexibility and control in determining the basic elements of a major source of revenue. Chapter XII will return to this subject from the perspective of a possible agenda for federal-provincial negotiations concerning sales tax integration.

The objective of this chapter is to describe the issues and reform options related to the system of indirect taxation currently in application in most provinces. The main focus is on the retail sales tax and the improvements that could be brought at that level. Issues concerning excise taxation (for example, taxes on gasoline and motor fuels, tobacco and alcoholic beverages) are also addressed.

2. Principles of Indirect Taxation

The fundamental principles of sales taxation are based on the assumption that a nation's resources will be allocated to their optimal use if the market process is allowed to operate freely. For this to occur in the presence of a sales tax, both production and consumption neutrality must be preserved.

The principle of production neutrality implies that a sales tax should not affect producers' behavior. This requires that all producer goods including raw materials, intermediate products and capital goods should be exempt from tax, while only final products are taxable. The taxation of producer goods involves two related issues: tax cascading and resource misallocation. The impact of a turnover tax (a tax on all transactions), as an extreme case of producer goods taxation, can be used to illustrate the negative effects involved.

> Taxing all transactions would be undesirable, however, because although there might be only one tax rate, it would be imposed again and again. There would be taxes on taxes, and as each good moved through successive stages of production and distribution, the taxes would accumulate; the more transactions there were to tax, the greater would be the increase in the final selling price. Consequently, the percentage by which the final price of a commodity would be increased by such a tax – the effective tax rate – would vary with the number of sales and purchases incurred in the production and distribution process. These cumulative effects are known as "cascading." We will not know how much the final price would be increased by the tax because we are never sure what proportion of a tax is actually shifted forward at each stage. But we do know that reducing the number of transactions would reduce the total tax payable and that a general turnover tax would set up an artificial incentive for firms to integrate and would penalize small firms and subcontracting. It would penalize investment too, because a firm buying capital equipment would have to pay the tax on these purchases.[1]

In addition, a turnover tax would discriminate against domestic manufacturing because imports of finished products would be subjected to fewer taxable stages. Exports would also be discouraged because it would be difficult to assess the value of taxes built into the final price of products for the purpose of remittance. Overall, these differential effects would result in resources being shifted from heavily taxed to lightly taxed sectors mainly on the basis of industry structure rather than productivity. For these reasons, a turnover tax is not compatible with economic efficiency.

Basically there are two methods available to avoid cascading of the sales tax. With the tax credit method, registered firms can credit the tax paid on their purchases from registered suppliers against the tax payable on their own sales. With the suspension technique, registered firms can purchase tax-free from other firms, and the tax applies only on purchases by unregistered firms or consumers. Manufacturers' and wholesale sales taxes are single-stage taxes that attempt to avoid tax cascading by using the suspension technique. However, it should be noted that these taxes do interfere with both production and consumption neutrality by inducing firms to push forward certain trading margins (for example, insurance and transportation) to later production or distribution stages in order to minimize taxable value. Furthermore, in practice the suspension technique cannot be applied perfectly, and the MST does fall on many business inputs and investment goods.

A sales tax should also be neutral in its effect on consumer choice. This requires that all goods and services be taxed uniformly. Otherwise consumers will adjust their purchases, substituting between untaxed or partially taxed items and fully taxed ones. This substitution will result in reduced demand for taxed items and a reduction in the factors of production used in the taxed industry. This could generate an inefficient allocation of resources and reduce economic efficiency. The loss in economic efficiency is referred to as an excess consumer burden. It means that consumers are not as well off as they would have been if the same amount of revenue had been raised by another tax that did not affect consumer behavior.

The loss of economic efficiency which results when the sales tax interferes with consumption and production behaviour imposes costs on the economy as a whole. These costs should not be underestimated. Efficiency is therefore a central issue in sales taxation.

Another issue concerns whether commodities are taxed on the basis of the location of consumption or on the basis of the place of production. The former are categorized as destination-based taxes and the latter as origin-based taxes. The destination principle is widely viewed as the preferable approach to coordinating sales tax among jurisdictions. In principle, a sales tax should not affect decisions about manufacturing locations by distorting the relative costs of home-produced and foreign-made goods. In theory, it should not matter whether exports are exempt and imports taxed or *vice versa* because the exchange rates and/or domestic prices will adjust accordingly. However, in practice, exchange rates and prices are not perfectly flexible and a destination-based tax with imports taxed and exports exempt is seen as more neutral in its impact. Furthermore, within the nation the common currency prevents any offsetting exchange movements, and so the destination principle is even more important for provincial sales taxes.

A further advantage of a destination-based tax is the ease of administration of border tax adjustments because taxable value is not an issue as it would be with an origin-based tax. Under a VAT, all prior stage tax is refunded in the case of exports. For imports, the value reported is not a concern as long as the goods are imported by registered firms. In the case of

the RST, imports are taxed when purchased and exports are not explicitly taxed except insofar as inputs used in their production may have been taxed.

3. Why Use Sales Taxes?

Sales taxes of either the single-stage or multi-stage variety constitute a significant portion of revenue for nearly all governments at both national and sub-national levels in most countries of the world. Sales taxes are historically the oldest taxes, and are often thought of as the most secure revenue source. They are also often thought of as regressive, since high-income households save more than low-income households and savers are often viewed as not paying the tax. This is somewhat of a misconception, however, since savers eventually pay the tax when they do reach the point of spending their savings. Furthermore, the indexation of transfer payments may over time reduce the progressivity of income taxes unless tax brackets are also indexed.

Sales taxes have no clear resource allocation rationale; they do not correct misallocations of resources elsewhere in the economy. They do, however, have the virtue of providing a secure revenue source. They also have the attraction of lower volatility in revenues over the business cycle than is true of income taxes for example. Because the latter are progressive taxes, in a business upturn revenues increase more, proportionately, than incomes. Equally in a downturn, income tax collections fall more, proportionately, than incomes. Under a sales tax, revenues generally rise or fall in proportion to incomes. While this lower volatility in revenues may be an advantage for government finances, nevertheless, it may be seen as a disadvantage from the perspective of stabilization policy.

As was indicated in Chapter III, the case for using a general sales tax is very much related to the type of direct tax in place. A serious distortion attributed to the broad-based income tax is the fact that it favours current consumption over saving and future consumption. Restricting the use of the PIT by relying on a general sales tax has the advantage of limiting the severity of this distortion. This argument is more relevant following Stage I of the federal tax reform. The changes in the PIT base significantly reduce some of the tax concessions that had been introduced in 1971 in order to favour saving and future consumption.

It has also been argued that relying more on sales taxation may reduce the work disincentive effects of the PIT. However this would require that a tax illusion take place such that the taxpayer would not perceive that the reduced tax burden on the income side is matched by the increased tax burden on the expenditure side. Perhaps the more important arguments in favour of using the sales tax relate to the fact that tax avoidance and evasion are more prevalent in the case of PIT and the fact that broad-based indirect taxes are efficient revenue raisers. There is also the widely held belief that a combination of direct and indirect taxes may provide governments greater scope to implement various economic objectives while minimizing specific tax-induced distortions and while collecting necessary revenues.

4. Retail Sales Tax Reform Issues

Although the retail sales tax can in principle be neutral in its effects on producers' and consumers' choices, this form of taxation as generally applied involves significant non-neutralities which generate economic distortions. Three elements of the system are at issue:

1. the numerous and sizable exemptions to the tax;
2. the exclusion of many services from the tax base; and
3. the fact that a substantial proportion of intermediary inputs and capital goods are taxed.

Exemptions

In principle the retail sales tax should "apply to all purchases of tangible personal property at a retail sale."[2] However, in practice all governments that use the RST as a source of revenue also implement a long list of tax exemptions. For the most part these exemptions can be classified into three categories: (a) those aimed at alleviating the tax burden on low-income taxpayers; (b) those to prevent the taxation of producer goods; and (c) those to prevent the double taxation of items already subject to another form of sales taxation. Provinces have in general granted many more RST exemptions than is the case for state sales taxes in the United States. In fact, exemptions reduce the sales tax base by almost 50 per cent in some provinces.

The significance of RST exemptions is a result of a number of factors. First, the RST has much greater visibility as compared to other forms of sales taxes which are not quoted separately, and this increases taxpayers' awareness of the tax. Also, generally "exemptions breed more exemptions." Once exemptions have been granted, it becomes politically difficult to withdraw these, and they signal the potential for further preferential treatment. Finally, because the RST is a tax on consumption its burden is perceived, in an annual context, to fall more heavily on low-income taxpayers who consume a relatively larger fraction of their income. Many of the exemptions commonly used seek to exempt from tax certain items which are considered necessities and make up a larger proportion of expenditures of low-income families as compared with those that are better off. This is seen as improving the fairness of the tax and therefore its acceptability.

However, with the exception of exemptions on producer goods, the case for limiting exemptions to an absolute minimum is very strong. First, there is the issue of neutrality. Exemptions imply tax discrimination in favour of the non-taxed goods and industry as well as the consumers of the non-taxed good. As a result, resources can be misallocated at a cost for the economy as a whole. The fact that each additional exemption reduces revenues substantially and usually results in a much higher tax rate being required to yield the necessary revenues further exacerbates the tax-induced distortions. Exemptions also create additional administrative complexity and scope for tax evasion and misapplication. Moreover, there is even some question as to whether certain exemptions actually accomplish their stated objectives.

Exemptions on food, clothing, footwear, prescription drugs and utilities aim to alleviate the burden of sales tax on low-income individuals by eliminating the tax on these items viewed

as "meritorious." However, there are several reasons to question this approach. First the exemptions are implemented at a great cost both in terms of tax revenue foregone and additional administrative complexity, and they reduce neutrality. Second, although some of these exemptions make the retail sales tax less regressive, it remains that they are provided to all taxpayers regardless of income. The 1987 White Paper indicated that for 1982, 64 per cent of the tax savings from exempting food went to the 50 per cent of households with incomes above the $25,000 median. In effect, the food, clothing, and footwear exemptions often extend to all items including luxury ones. It has often been argued that a more efficient way to alleviate the tax burden on low-income individuals is through a system of personal income tax credits specifically aimed at these individuals. Several authors have also questioned the effect of the clothing and footwear exemption.[3] It appears that such an exemption may in fact increase the regressivity of sales taxes because these expenditures make up larger percentages of the budgets of the rich than the poor.

Finally, it is often argued that the apparent regressivity of sales taxes in an annual context may simply be a reflection of life cycle and transitory income effects. This is explained by the fact that low-income groups will consist for the most part of young and elderly individuals and the temporarily unemployed whose consumption will on average be greater than their incomes, while high-income groups include a disproportionate number of middle-aged individuals with high savings rates. Viewed in a lifetime perspective, the pattern of sales tax burden is actually more or less proportional to income. It should be noted, however, that the life cycle incidence argument does not apply to the segment of the population who are apt to remain in the low-income group regardless of age due to lack of opportunity or some other reason. Nevertheless, recent studies suggest that the incidence of sales and excise taxes can be shown to be progressive or regressive depending on the assumptions that are made regarding the shifting of the tax. This ambiguity about the incidence of the retail sales tax has led several authors to question the suitability of the RST as an instrument for the pursuit of equity.

A further type of exemption is that which aims to prevent the double taxation of certain items. The gasoline and motive fuel exemption provided in most provinces is a case in point. Although avoiding the double taxation of articles subject to excises seems sound in principle, some questions have been raised about this type of policy. It can be argued that the retail sales tax should be extended to gasoline and motive fuels to facilitate administration and improve the neutrality of the RST. Furthermore, the excise tax on motive fuels can be seen as serving an entirely different purpose as a form of benefits tax that is related to road use to help finance highway expenditures.

The Taxation of Producer Goods

A recent study by Kuo, et al. (1988) reveals that only about two-thirds of provincial sales tax (64 per cent) applies to purchases of final products by households. The remaining tax is imposed on business acquisition of capital goods (8 per cent) and business purchases of intermediate inputs (28 per cent).[4] As already explained, this results in a tax cascading effect since taxes paid on business inputs are not relieved at later stages in the production chain. This cascading has the effect of producing higher taxes on multiple, more complex production processes, and also has the effect of discouraging exports. The estimates produced by Kuo, et al. (1988) indicate that, in general, provincial RSTs may be highly non-neutral with respect to

production and consumption choices and also that these taxes apply only partly on a destination basis since some of the tax built into production costs will filter down to export prices. Any move to redress some of these tax-induced distortions, particularly by eliminating the taxation of production goods and services, would greatly improve the efficiency of the retail sales tax and would reduce its costs.

The issues and problems related to the taxation of producers' goods have been recognized for quite some time.

> In general, the exemption of physical ingredients and parts from retail sales is a simple, administratively feasible and highly effective way of excluding from the taxes a substantial number of goods purchased for business use. But it by no means solves completely the problem of producers' goods. Under the usual definition of retail sales, purchases by business firms of fuel, industrial machinery, supplies, lubricants, motor vehicles, building materials, office equipment and the like; purchases by farmers of machinery, equipment and supplies; and purchases by merchants of fixtures and other goods not for resale are subject to tax unless specific exemptions are provided.[5]

The estimates produced by Kuo, et al. (1988) indicate that the taxation of producers' goods does remain a problem. Part of the reason relates to the classification difficulties in assigning either an intermediate or final consumption purpose to certain goods. The other problem is the potential tax revenue loss from excluding all intermediate goods from the tax base. John Due's (1964) earlier study of the provincial sales taxes proposed a general approach which still applies.

> As reconsideration is given to the tax structures, it is highly desirable that the principle be kept in mind that application of the tax to those elements entering in the cost of production and distribution as well as to the final products themselves is objectionable and should be minimized to the extent that exemption is administratively feasible.[6]

In practice however, it is not feasible to exclude from the tax many articles used by business firms, since such purchases cannot effectively be eliminated from the tax when similar items are frequently purchased for non-business use. Therefore, the exclusion of producers' goods must be confined to a few major categories.

(a) Materials and parts becoming physical ingredients of other goods. These are now universally exempt.

(b) Consumables, goods consumed in the manufacturing process, and exempt under the federal sales tax. This is a broader concept than the catalyst category now exempt in several provinces.

(c) Industrial machinery and equipment, exempt under the federal sales tax prior to 1963. This class represents a major item of business expense, and tax on it will deter business investment.

(d) Fuel and power for industrial use.

(e) Railroad rolling stock.

(f) Farm feed, seed, fertilizer, plants and trees, and livestock, the farm equivalent of materials and consumables.

(g) Farm machinery and equipment, but not tools and other small items, the exemption of which cannot be effectively controlled. Certainly the exemption of these items while other producers' goods are taxed is not entirely equitable. But it is far better to exempt the major categories than none at all.[7]

Exclusion of Services

Robinson (1986) points out that the early legislation in Canada relating to RST considered the tax as primarily a levy on the retail selling price of tangible property. As a result the taxation of services has until recently been avoided.[8] However as Due's (1964) study of the provincial retail sales tax suggested, there is no rationale for excluding all services from the base since these provide utility to consumers in the same way as physical goods do.[9] This position was later supported by three official provincial inquiries. In essence the exclusion of services affects the neutrality of the RST in much the same fashion as exemptions do, and consequently the exclusion of services involves the same sorts of distortions.

The question of taxation of services has received much more attention in recent years with the increased awareness of the growth of the service sector and the fact that the income elasticity of demand for services tends to be high. Services are seen as gaining much more importance in the economy, and the preferential tax treatment of this sector together with the potential tax revenue source it offers have become more of an issue.

However, there are a number of factors to be considered in regard to the taxation of services. First, there is the fact that much of the growth in services has occurred in the service categories that are not necessarily amenable to retail sales taxation. The largest growth has been in services to producers, in mixed services (where distinctions between consumer and producer transactions are difficult to make) and in social services like education, health care and public administration. Robinson (1986) concludes that the services which fall within the realm of taxation comprise only a small portion of the service sector.[10]

In principle, retail sales taxation should cover consumer services rendered by commercial establishments. According to Due (1964), it is better not to include personal services rendered by individuals because of the administrative problems that would result. As a matter of social policy, it is generally concluded that hospital, medical, dental and similar services should not be taxed. Some of the items to be included in the base would be: transient lodging; repair, cleaning, painting, etc. of taxable tangible property; installation, repair and cleaning of items designated as fixtures; laundry and dry-cleaning; servicing of motor vehicles; printing; entertainment admissions; and barber and beauty parlor work.

5. Provincial Retail Sales Tax

The level of reliance of provincial governments on the sales tax is very much related to the level of average income per capita in the provinces. Provinces with lower per capita incomes, like the Atlantic provinces, rely on the sales tax to a greater degree as a source of revenue than

do the wealthier provinces. In Quebec and Ontario, the personal income tax is the primary source of revenue, while sales taxes in these provinces are a significant but less important source of revenue. For 1985-1986, the sales tax constituted an average of 30 per cent of non-transfer revenues of the Atlantic provincial governments. The corresponding rates for Quebec and Ontario were 16 per cent and 23 per cent respectively. The percentages in Manitoba, Saskatchewan, and British Columbia were in the same range as Ontario's (14 to 19 per cent), while Alberta's was below 1 per cent. The lower percentages in Saskatchewan, Alberta and, to a lesser extent, British Columbia, are explained by the greater reliance on the part of these governments on natural resource revenues.

Table 8.1 demonstrates that RST rates vary dramatically across provinces. Newfoundland has the highest rate at 12 per cent followed by New Brunswick at 11 per cent, and both Nova Scotia and Prince Edward Island at 10 per cent. On the other hand, Alberta does not collect any RST and rates in the Prairie provinces are about half that in the Atlantic provinces. The higher rates applied in the Atlantic provinces could be viewed with some concern because of possible work disincentive effects and the impact on labour mobility not to mention the fact that higher rates in general exacerbate the distortionary effects of the tax.

Table 8.1 provides an interprovincial comparison of legislated sales tax exemptions in 1987. The major ones included food, utilities, gasoline and motive fuel, and clothing. While the gasoline and motive fuel exemption is justified in order to avoid double taxation, the other major exemptions are rationalized on the grounds of equity. It should be pointed out that in addition to legislated exemptions, the provincial RST system also involves *de facto* exemptions, that is, items that are not automatically taxable, even though they are not designated as exempt under tax law. This table indicates that New Brunswick and Prince Edward Island are generous in providing exemptions from the retail sales tax particularly with respect to electricity, clothing and footwear. Adult clothing and footwear receive complete exemptions only in these provinces. Other provinces like Nova Scotia, Quebec, and Ontario provide limited exemptions while the remaining provinces offer exemptions only on children's items. Items such as food, prescription drugs and medical appliances, and most books are exempt in all provinces. Goods taxed under excises are exempt in all provinces except Newfoundland and Ontario where tobacco products are subject to both taxes. This combination of RST and excise tax is also the case for alcoholic beverages in Prince Edward Island. Many provinces exempt thermal insulation materials and energy conservation devices.

The exemptions for producer goods also show some variation among provinces. Even though exemptions for production machinery, production consumables and processing materials are becoming the norm there remain inconsistencies. All provinces exempt farm machinery and equipment, farm products, seeds, and crops, farm livestock and feed, and fertilizers insecticides, etc. as well as commercial fishing gear and equipment. Production machinery is exempted fully in Newfoundland, Prince Edward Island, New Brunswick, Quebec and Ontario. Other provinces provide more limited exemption for specified machinery and equipment. Production consumables are exempt in Newfoundland, Quebec, Ontario, Saskatchewan, and British Columbia but only receive limited exemptions in New Brunswick and Manitoba. Processing materials are exempt in all provinces except New Brunswick. Building materials receive limited exemption in some provinces. Specific types of building materials are exempted in Prince Edward Island, Nova Scotia, Ontario and Saskatchewan.

Table 8.1 – Interprovincial Comparisons of Sales Tax Exemptions, 1987

	NB	NFLD	PEI	NS	QUE	ONT[2]	MAN	SASK	BC
Statutory Rates	11%	12%	10%	10%	9%	7%	6%	5%	7%
Commodity Class									
Food (Home Consumption	E	E	E	E	E	E	E	E	E
Prescription Drugs	E	E	E	E	E	E	E	E	E
Electricity	E	T(3)	E	T	T(4)	E	T(5)	T(6)	T(7)
Firewood	E	T	E	E	E	E	E	E	E
Water (Health Purposes)	E	E	E	E	E	E	E	E	E
Classroom Supplies	E	T	E	E	E	E	E	E	E
Restaurant Meals	E $1.00 or less	T	E $2.00 or less	E $4.00 or less	E $3.25 or less (13)	E $1.00 or less	E $6.00 or less	E	E $6.99 or less
Footwear	E	E Children (9)	E	E $150 or less	E $125 or less	E $30 or less	E Children	E Children	E Children
Clothing	E	E Children (10)	E	E $300 or less	E $500 or less	E Children	E Children	E Children (12)	E Children
Farming Equipment	E	E	E	E	E	E	E	E	E
Fishing Equipment	E	E	E	E	E	E	E	E	E
Production Machinery	E	E	E	E(8)	E	E	T	T	E
Goods Purchased for Production by a Utility	E	T	T	E	E	T	T	T	T
Clay, Sand & Gravel	E	T	E	E	T	E	E	E	E
Telephone Equipment	E	T	T	T	E	E	E	T	T
Thermal Insulation	T	E	E	E	T	T	E	T	E
Books	E	E	E	E	E	E	E	E	E
Dry-cleaning	T	T	T	E	E	E	T	E	E
Biologicals and Medicaments	E	E	E	E	E	E	E	E	E
Second Hand Mobile Homes	E	T	E	E	T	E	T	E	E
Liquor	T	T	T	T	T(13)	T	T	T	T
Railway Rolling Stock	T	T	T	T	T	T	T	T	T
Plants, Shrubs & Trees (other than food sources)	E	T	E	E	T	T	T	E	T
Goods purchased by Indians	E	E	E	E	E	E	E	E	T

E – Exempt T – Taxable

1 Alberta has no sales tax.
2 Exempts large trucks/trailers.
3 Exempts for domestic and manufacturing uses only.
4 Exempts for manufacturing up to 90 per cent of quantity purchased.
5 Exempts for domestic heating only, cooking and lighting are taxable.
6 Exempts for domestic and commercial heating and manufacturing uses.
7 Exempt for domestic purposes only; includes heating, lighting and cooking.
8 Not exempt if equipment is used in production/processing of non-renewable resources (4% rate applies).
9 Adult footwear exempt per item up to $125.00 for areas along Quebec, Newfoundland border.
10 Adult clothing exempt per item up to $500.00 for areas along Quebec, Newfoundland border.
11 Used adult footwear valued at $20.00 or less.
12 Used adult clothing valued at $100.00 or less.
13 10% rate applies.

Note: Comparison based on New Brunswick's exemption structure. Additional exemptions may apply in other provinces.

There has been a trend across provinces in recent years toward base broadening of the RST to include more services. There is much variation across provinces in this respect. As was pointed out by Robinson (1986) the principle of taxing services has become well established in Canada. However, its occurrence is still not as common here as it is in the United States. Service categories such as telecommunications, transient accommodation, and some repairs to tangible personal property, are currently taxed in most provinces. Gas and electricity, dry-cleaning, printing, advertising and leases of taxable goods are also taxed in some provinces. It should be pointed out that some of these items are taxed under separate legislation in certain provinces, for example, insurance premiums, admissions and gas are taxed in New Brunswick but not under the retail sales tax. The taxation of services in the United States (particularly in Hawaii, South Dakota and New Mexico) covers a broader range of items including travel tickets, installation of appliances and equipment, private club fees, and some professional services (for example, architects, accountants, barbers and beauticians).

6. Excise Taxes

The rationale for using excise taxes is very different than that for broad-based sales taxes like the VAT and the RST. By definition, excise taxes apply to specific commodities, and in that sense, discriminate specifically against the taxed goods. However, there are a number of reasons to justify their use. For instance, such taxes can be used to increase the progressivity of the overall tax system by exploiting the differing elasticities of demand for various commodities. Taxes levied on the consumption of luxury items have traditionally been used for this purpose. Similarly, by exploiting the differing price elasticities of demand for various commodities, excise taxes can be used to collect revenues while minimizing efficiency costs. In other words, taxes on products for which the demand is not very sensitive to price increases are more efficient since they do not alter consumption patterns as much as would taxes on products with an elastic demand.

Second, to the extent that a tax can be aimed at consumption directly related to benefits derived from specific public expenditures, the benefits principle of taxation may apply. Taxes on gasoline consumption are a good example. Such consumption can be seen as complementary to highway usage. Therefore, the more an individual taxpayer makes use of public roads, the more the taxpayer contributes to the expenditures related to highway repair and construction through the gasoline tax. It should be pointed out here that provincial gasoline and motive fuel excise taxes do not strictly adhere to the benefits principle. The principle only applies in this case to the extent that the consumer of motive fuel pays higher taxes as a result of additional highway use. However, as Robinson (1986) points out, although the statistics indicate a high correlation between motive fuel taxes collected and provincial highway expenditures, for the past 30 years the latter have exceeded tax revenues to a significant degree. Moreover, for the portion of the excise tax which does not apply to fuel used for highway transportation the benefits argument is irrelevant.[11] The issue of production neutrality may apply here as well. Such a tax, if applied on highway usage for production purposes may discriminate against specific industries or activities and also result in tax cascading. However, it is generally argued that to the extent that the benefits principle of taxation applies, the excise tax on gasoline and motive fuel should extend to all highway users. In principle, therefore, gasoline motive fuel tax exemptions should be avoided where the consumption occurs on public highways.

Finally, excise taxes on products such as tobacco and alcohol are often justified because the consumption of these products is believed to generate costs for society as a whole. The externalities are costly both implicitly in terms of productivity loss and explicitly through the resulting increase in health care and crime prevention services required. Such taxes are regressive, however. The consumption of these commodities constitutes a larger share of the income of low-income families as compared to that of higher-income families.

A comparison of provincial excise tax rates indicates that gasoline is taxed heavily in Quebec as compared with most other provinces, particularly the adjoining ones. In 1987, for example, the rate in Quebec was 13.65 cents per litre while that in other provinces ranged from 7.7 to 9.8 cents per litre. Saskatchewan did not levy gasoline taxes and Alberta only applied a rate of 5 cents per litre. The rate differentials on diesel fuel were also similar. In the case of tobacco, the provincial rates are more similar, although Ontario has stood out with a significantly lower rate. The issue of whether Ontario or other provinces should increase tobacco taxes is probably more a matter of social objectives and revenue requirements than economic judgement. The same argument can be made in the case of liquor taxes (both excises and profits from the sale of liquor).

7. Retail Sales Tax: Directions for Reform

The most important tax reform decision that provinces will have to make in the next few years is whether or not to integrate their RST with the goods and services tax of the federal government. If the provinces choose to maintain their sales tax autonomy, it is likely that the issue of RST reform will have to be addressed. The previous sections have reviewed the basic principles of indirect taxation and the major reform issues related to the RST. We have also provided a fairly detailed description of provincial RST systems with respect to current exemptions and exclusions from the tax base. On the basis of this information the broad direction for reform is fairly clear, although not easy to implement.

Evidence suggests that the RST is not the appropriate instrument either to implement equity objectives or to provide incentives for specific economic activities. The main advantage of the RST is its revenue raising capacity and the fact that it can be used to relieve pressure on other forms of taxation. In light of this, RST reform efforts should be focused on the efficiency aspects of the tax. As a rule, the more neutral the tax is in its application, the more efficient it will be. The emphasis should be on removing the imposition of the RST on producer goods to the extent that it is administratively feasible. Such practice results in tax cascading, higher export prices, and the misallocation of resources in the production process which the provincial governments should seek to eliminate.

Another important reform objective should be the broadening of the RST base and a reduction of rates, particularly in the Atlantic provinces where rates are substantially higher than elsewhere. The purpose here would be to improve the neutrality of the tax and reduce its efficiency costs. Another advantage of base broadening is the reduction of administrative complexity. This would correspondingly allow for a lowering of the rate which would also temper the tax-induced distortion including the work disincentive effects and the encouragement of non-market activities.

In order to accomplish this, the provincial governments should reassess all current exemptions to determine whether these fulfill their intended purpose; whether the benefits they provide warrant the associated costs in terms of additional administrative complexity and non-neutrality; and whether tax exemption is in fact the most efficient way of accomplishing the task at hand:

- **Food, prescription drugs and utilities**. These exemptions are almost universal. They lessen the burden of RST on low-income taxpayers and improve the perceived fairness of the tax by exempting items considered necessities. However, these exemptions (food in particular) involve considerable reduction of the tax base and may be particularly inefficient because the exemptions apply to all taxpayers regardless of their ability to pay. The provinces should study the possibility of eliminating these exemptions and replacing these with a system of personal income tax credits specifically aimed at reducing the tax burden on low-income families. This measure would not only improve the efficiency of the RST, it would also make the overall tax system more progressive. Such a move would be made considerably easier if a number of provinces, if not all, developed a consensus in this respect. Nevertheless, it is likely that great political resistance would develop if such a move were seriously contemplated.

- **Clothing and footwear.** This exemption should be reconsidered. Indications are that this type of exemption does not reduce the regressivity of the RST. Again the equity objective is probably better served through PIT measures.

- **Books, newspapers and library purchases.** These exemptions are seen as contributing to an informed and educated public. This objective would be better addressed through the subsidy system. The value of the exemptions is quite small and therefore not likely to have much of an impact. These should be removed to the extent that it is administratively feasible to broaden the base, reduce administrative complexity and improve the neutrality of the tax.

- **Gasoline and Motive Fuel.** The rationale for this sizeable exemption is to avoid double taxation. However, there is a case for removing the exemption on gasoline and motive fuel for personal use to the extent that the excise tax on gasoline and motive fuel is a benefits tax related to highway usage and used to finance highway expenditures. Such a move would broaden the base considerably and reduce the efficiency costs of the tax. There are a number of problems with this approach, however. First, in spite of a number of recommendations in favour of this approach, all provinces continue to exempt gasoline and motive fuel. Second, the gasoline and motive fuel tax not only applies to purchases of gasoline for highway use but other uses as well. Third, the rate of excise taxation on fuel is considered to be already substantial. Finally, implementing an RST on motive fuel would require a system to prevent the tax from falling on producers.

Another way of broadening the retail sales tax base would be to tax more consumer services. Provinces currently limit service taxation to categories commonly taxed in most other provinces. There are a number of other service items which could be brought into the base. For example, printing, photocopying and microfilming, advertising, private club fees

and perhaps even some professional services offered by commercial establishments such as architects, accountants, barbers and beauticians.

In principle, purchases of services by consumers should be taxed at the same rate as purchases of tangible goods. The problem with many services is that it is sometimes difficult to distinguish between purchases for business purposes and those for personal use. On the other hand, the taxation of services would eliminate some of the administrative complexity associated with having to exclude from the tax base the service element in sales of tangible personal property requiring various forms of services (e.g., installation). One possible method of avoiding the taxation of producer services would be to allow all registered firms to make all purchases of services tax free and account themselves for the tax applicable on the portion of services used for private use.

For each province, the choice of appropriate exemptions and the decision to include certain services will persist as reform issues. Meanwhile, the objective of business competitiveness will repeatedly focus attention on the taxation of business inputs and investment goods. The desire to minimize tax cascading will remain an essential concern in the RST reform process. Chapters XI and XII will consider the alternative reform approach of eliminating the RST and entering an agreement to share the new proposed federal value-added tax.

Notes

1. A.J. Robinson, *The Retail Sales Tax in Canada*, Canadian Tax Papers, No. 77 (Toronto: Canadian Tax Foundation, 1986), p. 40.
2. *Ibid.*, p. 56.
3. See for example, W.E. Schrank and J.P. Feehan, "The Regressivity of Newfoundland's Consumption Tax Structure, 1974-1982," *Canadian Tax Journal* 32 (1984), pp. 294-309.

   David G. Davies, *United States Taxes and Tax Policy* (Cambridge: Cambridge University Press, 1985).

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Chapter IX

Factor Specific Taxes

1. Introduction

Although both the federal and provincial governments rely heavily on three basic forms of taxes (the personal income tax, the corporate income tax, and the sales tax) to collect revenues, there are a number of alternative forms of taxation that deserve attention, particularly from the standpoint of a provincial government considering the reform of its tax system in the aftermath of federal tax reform. For example, if the provinces opt for a joint federal-provincial sales tax with a uniform tax rate, some provincial governments may feel the need to increase their reliance on other forms of taxation such as factor specific taxes. Recent provincial budgets, such as those of Ontario, already offer evidence to that effect. This chapter presents some of the general issues which relate to the implementation and the impact of factor specific taxes, including payroll taxes, capital taxes, resource taxes, and property taxes.

2. Payroll Tax

One of the major options to be examined by provinces in the context of tax reform is that of a payroll tax. This would be a new and potentially major tax source which could be used in combination with other taxes to relieve pressure on the sales and income tax front. The payroll tax is a tax on labour income for businesses employing labour. The tax can be applied in several different ways. It can be a flat percentage of payroll paid fully by the employer; or a flat percentage paid by the employee; or, as is typically done, a combination of employer and employee contributions. It can also be a flat percentage up to a ceiling beyond which a predetermined maximum contribution level applies. This is a commonly used device, for example, with the social security tax in the United States, and with Unemployment Insurance and Canada Pension Plan contributions in Canada. If there were concerns over the

regressivity of such a payroll tax, it could be charged as a flat percentage of payroll above a certain threshold level of wages per employee.

In addition to the different definitions of the base that could be adopted, the tax could also be designed in various ways. There could be, for instance, differential payroll taxes depending upon age or depending upon the family characteristics of the employee involved. It could also be the case that the second earner in the family is exempt of payroll taxes thereby alleviating some of the work disincentive effect of the tax.

In its effects, the payroll tax is much like a credit invoice value-added tax. Under a VAT, taxes on all capital expenditures are creditable in calculating taxes owing. The VAT taxes the total value of sales but allows a credit for taxes paid on material inputs. Because taxes paid on capital equipment and other investment are creditable, they offset taxes paid in future periods on the income return to assets in the form of value added. The net effect of a VAT, therefore, is to tax labour income as it accrues in the form of value added at the firm level. This is the same effect as a payroll tax. It should be noted that the imposition of either a payroll tax or a value-added tax may impact existing capital differently than new investment, and in this transition period the greater tax incidence on existing capital may be considerable.

Payroll taxes do, however, differ from a VAT in a number of crucial ways. If a third, non-capital and non-labour factor of production (land) is taken into account this equivalence breaks down, since under a VAT the income return to third factors is taxed while under a payroll tax it is not. Also, a VAT is usually applied at the point of consumption, that is, on a destination basis. Imports into the province are taxable, and taxes are rebated on exports. In contrast, a payroll tax operates on an origin basis. Because it is applied at the point of production, it can be built into production costs. It should also be noted that this origin basis means the payroll tax will impede export performance by the province.

A tax of this form can clearly be used as a device to relieve pressure elsewhere in the fiscal system, and on that basis, may be viewed as highly attractive. In cases where provinces are trying to attract inward investment, concerns over taxing the income return to assets and the effects this may have on factor mobility would be down-played substantially. The payroll tax is fundamentally seen as a tax on a fixed factor and, from that point of view may also be viewed as attractive.

However, the negative aspects of the tax are equally apparent. The payroll tax is seen as a regressive tax, and will be so if there are ceilings to contribution levels. It is, at best, equivalent to a VAT, but once land is taken into account it has a smaller tax base. Whereas a payroll tax has to be collected by the province, a joint federal-provincial VAT or goods and services tax may give the province the chance to raise revenues with only small additional collection costs. Also, a payroll tax is an origin-based tax. It gets added into export costs thereby affecting the export potential of the province. The most common argument against payroll taxes is the incidence argument that a tax on payroll is regressive. Because of the ceilings which apply to them, the component of the tax which applies to labour income falls as a percentage of income, as income rises. This incidence difficulty can partly be overcome by not using ceilings in applying the tax.

Payroll taxes have been widely used in a number of countries although typically not at the sub-national level. In most cases, the taxes are a method of funding old age security and health care programs, and so can be seen as based to some degree on the benefits principle. For

instance, in Austria, Sweden, Greece and most West European countries, social security taxes represented well over 30 per cent of tax revenues in the 1980s. The United States has also relied heavily on this form of taxation. While Canada derived only 13 per cent of tax revenues from social security taxes in the 1980s, in the United States the percentage was about 29 per cent. A number of countries have also imposed unearmarked payroll taxes, that is, taxes not specifically designed to finance social programs. In the 1980s, these taxes accounted for about 5 per cent of revenues in Australia, Austria and Sweden.

The most common payroll tax at the provincial level in Canada is the worker's compensation levy. In addition, both Quebec and Manitoba have levied a tie-in payroll tax. In 1987, employers in Quebec were subject to a tax equivalent to 3.22 per cent of wages dispensed. This tax represented the employer's contribution to the Health Services Fund. In Manitoba the payroll tax rate was 2.25 per cent, and the revenues collected helped to finance education and health care expenditures. Ontario has also recently introduced a payroll tax to replace its previous health insurance premiums.

It is often argued that people-related services, such as health care and education, should be financed according to ability to pay. The payroll tax on employers is not compatible with this principle of taxation. First, there is no reason to believe that a business's payroll is related to ability to pay. Second, the employers are often in a position to shift the tax burden either forward onto consumers or backward onto labour. The latter possibility is usually considered the more likely and to the extent that the tax burden is allocated in proportion to wages the tax would be non-regressive. However, the ability of employers to shift the payroll tax will be related to factors such as the presence of labour unions, labour supply conditions, labour mobility, the size of the firm and its control over its terms of trade. The employer payroll tax could therefore be borne more heavily by lower-income employees. It is also possible that the effective tax burden could be different depending on the results of wage negotiations for individuals with otherwise similar circumstances. Further, to the extent that the tax was built into production costs, it could be passed onto consumers both within and outside the jurisdiction. Taxes on consumption are often regressive and tax exporting is generally perceived as inequitable. On the other hand, if the tax cannot be shifted it simply adds to the costs of production within the province.

These same arguments also weaken the case of tie-in payroll taxes as benefit related. Not only is it possible for the tax to be borne by individuals who do not benefit from the services which the tax helps finance, but also where such payroll taxes apply there is simply no relation between taxpayer service usage and taxpayer payments. For that matter, there is also no relation between tax revenues collected and levels of expenditures incurred.

The social levies collected in Alberta and British Columbia and, until recently in Ontario, to help finance their medical insurance programs can also be considered a form of payroll tax. It has been argued that such levies are compatible with the benefits principle of taxation in that premiums are collected from the users of medical services. Also, because lower contribution rates apply to low-income individuals and because senior citizens and welfare recipients are exempt, the tax is perceived as related to ability to pay. However, there are several issues related to these schemes which should be emphasized.

Medical insurance plans, as currently administered, are not benefit-related because:

1. the premiums paid are totally unrelated to usage of medical services;

2. the revenues collected through such schemes only finance a minor portion of total health care expenditures;

3. the level of health care expenditure is unconstrained by the level of premiums collected; and

4. in many cases the premiums have become part of the fringe benefits provided by employers – and as such are no different than the payroll taxes levied in Quebec and Manitoba.

It is true that health care premiums reflect ability to pay but only to the extent that welfare recipients, senior citizens and low-income earners are subsidized by the plans and to the degree that contribution levels are set to take account of the number of dependents involved. However, just as is the case with unemployment insurance and pension plan contributions, health care premium rates are only related to income up to a predetermined, relatively low taxable income ceiling, for example, $6000 in Ontario in 1987. Above that ceiling, payment levels are flat which means that they decrease as a percentage of income as income rises. Also, to the extent that employers pay the premiums as supplementary labour income, the aforementioned arguments related to tax shifting and ability to pay would apply.

To conclude, there appears to be no economic rationale to apply either a tie-in employer payroll tax or a social levy to help finance people-related services such as health care or education at the provincial level. Such taxes are not compatible with either the benefits or the ability to pay principles of taxation, and because of this it is preferable to continue to finance these expenditures out of general revenues. Moreover, there are practical considerations that would seriously affect the efficiency and compliance costs of such taxes for some provinces. Provinces with lower levels of per capita income generally have more welfare recipients, senior citizens, and low-income earners than the other provinces. They also have higher than average unemployment levels, more seasonal employment, and lower income levels per capita. Such factors would significantly affect the degree to which social programs have to be subsidized as well as the size and stability of the tax base. There are other elements to consider when evaluating the efficacy of provincial payroll taxes. For instance, the average proportion of very small firms (premiums are usually submitted by firms above a predetermined threshold size) and the percentage of the labour force that are government employees, would certainly complicate the administration of such a tax.

As suggested earlier, if it was felt that an additional source of revenue was required to relieve pressure elsewhere in the tax system, a general purpose payroll tax could be designed in such a way as to remove its regressive pattern (by not using wage ceilings and/or by applying the tax above a specified wage level per employee). The work disincentive effect of the tax could also be reduced by exempting second earners or taking family and age characteristics into account. However, the concerns would still remain over the efficiency of such a tax as a revenue source for smaller, less wealthy provinces, together with the issues of the export bias of this origin-based tax, and the administration costs of a new tax.

3. Capital Taxes

Currently, only Prince Edward Island and Alberta do not impose taxes on the capital of a corporation having a permanent establishment in the province. In Ontario, Quebec, Manitoba, and Saskatchewan, the tax applies to both financial and non-financial corporations, while in the remaining provinces only banks and trust companies are subject to tax. Although the definition of taxable capital varies somewhat among provinces, it essentially consists of paid up capital, earned surplus or retained earnings and other surpluses, reserves and various loans and advances received, less certain allowances for investments and goodwill. In 1987, the general rate varied between 0.3 per cent in Ontario and 0.5 per cent in Saskatchewan. The rates on the paid up capital of banks ranged from 0.8 per cent in Ontario to 3.0 per cent in Manitoba and Saskatchewan. The provinces prevent double taxation by using the income tax allocation rules based on sales and payroll in the provinces to impose tax only on the capital employed in the province. According to Sheppard,

> [t]he tax is popular with provincial governments but not some policy analysts. The tax catches a company that escapes income tax because it has no taxable income. It diverts tax revenue to the province that would otherwise have gone to Ottawa because the taxpayer may deduct the tax in computing taxable income .... The Belanger Commission (1965) and Smith Committee (1967), felt that the tax should be repealed because it violated adequacy, practicality, equity and neutrality. Since it diverts tax revenue from the federal government, we might add that the tax violates political order.[1]

As was pointed out by the Belanger Commission on taxation in Quebec, this tax distorts the terms of interprovincial competition. It essentially discriminates against domestic producers by increasing their production costs. Perhaps Wolfe D. Goodman's (1986) estimates help most in putting the effects of this particular tax in perspective. He equates the tax to an annual wealth tax (as held indirectly through corporations) and indicates that the current 0.3 per cent rate in Ontario "can be regarded as the equivalent of a flat wealth tax of about 24 per cent every 30 years, using the rather modest interest rate of 6 per cent. This is, of course, a formidable wealth tax by international standards."[2] This observation lends support to the concerns expressed over the detrimental effects of this tax in Quebec where the general capital tax rate has been the highest.

In terms of economic criteria, this tax does not appear to have much to recommend it. It discourages new investment, and it creates incentives for mobile capital to leave. As a result, the effective burden of the tax rests on labour, to the extent that labour is immobile, and on landowners. From the provinces' point of view, the main advantages of using this form of taxation are that the tax will reach companies with no taxable income within the jurisdiction (particularly banks) and that it will divert tax revenue from the federal government to the province. Capital taxes are deductible against the CIT so in effect, revenues raised through such a tax exceed the burden placed on corporations. It should be pointed out that the fact that the majority of provinces now levy capital taxes reduces the importance of the capital mobility argument against corporate capital taxation.

4. Resource Taxation

The corporate income tax as it is presently structured results in the preferential treatment of resource industries. This sector faces relatively low effective tax rates due to preferential tax

measures such as accelerated depreciation allowances, investment tax credits and earned depletion. According to the 1987 White Paper on Tax Reform, about 50 per cent of the financial statement income of the mining industry was not subject to tax. This compared to an average of 27.6 per cent across all industries. According to Boadway and Bruce (1985), the arguments for these tax preferences – such as the assertion that investment in these industries is riskier, more capital intensive, and faces a capital market bias – do not support their continuation.[3] All of these problems can be addressed more adequately and efficiently through the full write-off of exploration and other costs.

An additional problem in the context of resource taxation has to do with the fact that the provinces, who have jurisdiction over natural resources, currently levy a wide array of taxes on resource industries "varying from income taxes at various rates on minerals, to royalties on minerals and natural gas, as well as fees for the use of Crown lands for exploration, production and timber."[4] Since these taxes are not deductible from any other tax, tax cascading is a definite possibility, not to mention the fact that the resulting tax differentials can distort interprovincial trade. There are however a number of principles which, if taken into consideration in tax design, would lead to definite improvements overall.

First, while objectives such as resource management and development may motivate tax policy in this area, the main purpose remains that of capturing rents either fully or partially. In the case of resource industries, the value of rent is the difference between the total revenue generated from the sale of resources and the total costs incurred in extracting. On theoretical grounds, the taxing of economic rents is preferable to the taxing of other sources of income because it does not introduce distortions in the economy. It is neutral in its impact on resource allocation. "Resource rents are particularly attractive because of their size and because they are unearned returns – a natural heritage – so that heavy taxation does not violate equity notions."[5] The simplest form of taxation on rents is a profits tax with a tax base defined to reproduce the cash flow of the resource producing corporations (that is, all revenues realized less the sum of current costs on a cash-flow basis). Such a cash-flow tax would require that a system of complete loss offsetting be implemented. Alternatively, the tax base could be designed to approximate the flow of rents by including all revenues and deducting current costs on an accrual basis. This type of system, like any other requiring measurements on an accrual basis, is more difficult to design and administer.

An important fact to consider is that the current federal and provincial tax systems do not tax resource rents directly. The corporate income tax is partly a profits tax, but because exemptions provided for capital and resource costs significantly overstate these costs, it is ineffective in capturing the rents. Provincial resource taxes are for the most part royalties based on the value or the level of production. These royalties are inappropriate for taxing rents because revenues and profits are not necessarily correlated. For instance, it is possible that certain operations will report substantial revenues and very little profit due to relatively high expenditures incurred. Also, royalties on revenues are distortionary because of their disincentive effects on production.

There are other instruments of rent collection available. In principle, lease auctions to exploit the resources on Crown lands could fully capture expected resource rents. Difficulties include the likelihood of noncompetitive bidding taking place and the fact that expected rents, because of uncertainties, might differ from actual rents. Crown corporations and *in situ*

taxation are other possibilities although they involve considerable administrative and political difficulties.

Many of these issues are discussed in a book edited by Thomas Gunton and John Richards, *Resource Rents and Public Policy in Western Canada*. The authors have examined several sectors, including hydroelectric power, nickel, potash, uranium, forestry, and fishing. Apart from taxation, they consider four other techniques that provincial governments use to collect rents: royalties, competitive bidding, marketing boards, and public ownership. They conclude that the appropriate choice of technique depends upon the particular circumstances at a given time.

> In general, the more competitive the market is for the right to exploit a resource, the more appropriate it is to capture rent by competitive auction. The more uncertainty surrounding the net benefits to be generated, and the more important the oligopolistic tendencies among private producers, the greater the degree of public intervention and entrepreneurship needed. Since one rent-collection technique can often compensate for the disadvantage of another, a combination of techniques is desirable. Competitive bidding, for example, can be used in conjunction with royalties to collect residual rent. A crown corporation, meanwhile, can provide the information and bargaining power to government needed to make competitive bidding and taxation work. Competitive bidding and private sector competition in turn can force crown corporations to remain efficient.[6]

The authors suggest that provincial governments have not utilized these alternative revenue-raising techniques adequately or appropriately:

> Certainly many of the initial rent-capture mechanisms put in place by government during the 1970s were hastily devised and generated inequities; they left sizeable rent with some producers, while reducing returns of others below normal.[7]

The authors believe strongly that substantial additional revenue should be raised by provincial governments from these alternative techniques.

As will be discussed in Chapter X concerning the federal government's equalization payments, the issue of resource rents and their collection by the provincial and federal governments is of central concern in regard to equity within the Canadian federation. Natural resource rent-collection by one province may increase prices paid by the residents of other provinces. Although resources are decreed by the Constitution to be a provincial responsibility, nevertheless, the residents of a resource-poor province may feel it unfair if they cannot share in the rents from resource-rich areas within Canada. The decisions of any one province in regard to the collection of resource rents may impact the federal-provincial fiscal arrangements. Consequently, the appropriate federal-provincial sharing of resource rents, particularly through the process of equalization payments, has been of paramount concern and has repeatedly attracted public attention as a particularly sensitive political subject.

Several of the issues relevant to resource taxation came to light during the implementation of the National Energy Program. Conflicts in federal-provincial interests, due mainly to regional disparities in resource rents and the issue of rent exporting, became important political issues. The policy which was adopted created enormous controversy. Such conflicts are probably the source of some of the inefficiencies in rent collecting. Indeed, the ways in which provinces have taxed resource industries do not reflect the more ideal forms of rent taxation. The federal government, on the other hand, has used price regulation and export taxes as a means of achieving regional redistribution of rents and decreasing rent

exports to non-resident owners. Any reform in this area would therefore require upfront federal-provincial cooperation to tax resource industries on a consistent and more efficient basis. Boadway and Bruce (1985) recommend that a combination of lease auctions and cash flow profits tax, accompanied by a removal of traditional tax preferences, be considered.[8]

5. Property Tax

The property tax differs significantly among Canada's provinces in several important respects. These differences make interprovincial comparisons difficult and limit the usefulness of generalizations about property taxes.

In most provinces, the property tax is levied by municipalities, with both rates and assessment procedures varying among municipalities. Hence it is not realistic to treat a province's property tax as a uniform structure against which to make interprovincial comparisons. Furthermore, the services provided by municipalities in return for the property tax vary among municipalities. A low property tax may simply reflect a minimal level of municipal services, accompanied by larger private sector expenditures to purchase these services privately. A high property tax may similarly reflect a high level of expenditure responsibilities borne by municipalities. Without examining the services provided at the municipal level, interprovincial comparisons of the property tax can be misleading for this reason as well. Moreover, in some provinces, municipalities have a relatively low property tax but also levy a business "occupancy tax." Without including such additional taxes and fees, a simple interjurisdictional comparison of property taxes may be misleading.

These features of municipal finance mean that property tax reform will not affect all municipalities equally. Furthermore, tax reform may impact provincial grants to municipalities. Apart from these complexities, there is an additional political perspective that has traditionally played an important role in affecting the rates and structure of the property tax. Many governments view home ownership as a basic social objective. Hence a property tax may be designed to assist home ownership quite apart from the rationale of economic efficiency or payment for benefits received. Reform of the property tax must be considered in light of these special features.

It is important to discuss the issue of property tax reform in the context of provincial tax reform for a number of reasons. As already mentioned, any changes in property taxation at the municipal level would affect local revenues and therefore the extent to which provincial governments are called upon to contribute to the financing of local services. Also, the property tax has been the subject of general criticisms and appeals for reform, especially on administrative grounds. The several studies on this subject have been fairly unanimous in their recommendations. It is felt that the full assessment of all property at full market value would eliminate the sizeable discrepancies in effective rates. Tax relief would be more efficiently provided through tax credits, or subsidies, rather than through property tax exemptions. Assigning assessment functions at the provincial level is seen as a way of reducing inconsistencies in assessment practices. It is also likely to result in a more efficient system. Finally, it is strongly recommended that the responsibility for people-related services such as education, health, and welfare, be limited to the provincial level in order to guarantee more uniformity in the quality of services provided and in their availability. Localities should

maintain their autonomy in setting property tax rates to the extent that rate differentials reflect differences in the level of property-related services provided.

From the perspective of aggregate provincial and municipal revenue, the property tax has become a less important source of revenue in the past 60 years. Bearing in mind the qualifications expressed above in regard to interprovincial comparisons, property taxation is used to a widely varying degree among the provinces. In 1987, property tax collections as a percentage of provincial government own-source revenue ranged from a low of 2.0 per cent in Newfoundland to a high of 29 per cent in Ontario and Manitoba. Property tax payments, as a percentage of personal income also varied across provinces, although not as dramatically.

With the provinces looking at significant changes in tax bases as a consequence of the federal tax reform, and given indications that the federal government may reduce its inter-governmental transfers, provincial governments may wish to reconsider a reformed (more equitable and less distortionary) property tax as a potential source of additional revenue.

There are three major reform issues related to the property tax. The first issue is whether the property tax can and should be used as a benefits-related tax. The second issue concerns the incidence of the property tax, that is, whether it is in fact a regressive tax. The third issue involves the distortionary effects of the tax, which are a direct consequence of effective rate differentials.

Property Tax as a Benefits Tax

A common argument in the literature on property taxation is that property-related services should be financed based on the benefits principle of taxation while people-related services should be financed based on ability to pay. Although there is some correlation between the value of residential property owned and ability to pay, it is generally agreed that comprehensive income is a better indicator of ability to pay. Furthermore, there is no reason to believe that the value of property owned in business is related to ability to pay. The fact that the non-residential rate is generally higher than the residential rate is inconsistent with the fact that property tax-related benefits (particularly people-related benefits) accrue largely to residents as opposed to business.[9]

According to the benefits view of property taxation, such a levy should constitute a set of user charges for locally provided public goods and services. Under this approach, local differentials in effective property tax rates would simply reflect local differentials in the level of public services provided and, as such, would not be capitalized into land rents. According to Hobson (1987), in an economy with many jurisdictions, each offering a distinct tax and expenditure package and with fully informed and perfectly mobile economic agents, a benefits-related property tax would not result in the misallocation of resources.

Bossons (1981) argues that the level of property taxes paid should reflect the costs of providing services such as fire and police protection, sewer and water, but not people-related services such as education and welfare.[10] This approach would require non-uniform effective tax rates that reflect differences in the average cost of providing local services. An appropriate rate structure applied to a base assessed at market value would likely result in higher property tax rates in the low density areas rather than the high density areas, and differential

rates across classes of property (commercial, residential, industrial) reflecting the value of services provided to these.

In provinces where equalization payments to municipalities are already in place and people-related services are the responsibility of the provincial government, the transition to a benefits tax would not be as disruptive as it may be elsewhere. With a benefits property tax in place, incidence would only remain an issue to the extent that people-related services are financed partly through the income tax (a progressive tax) and partly through the retail sales tax (a regressive tax). The main transition problem to contend with would be that which results from the significant changes in the rate structure. Indications are that there would be a considerable increase in taxes paid on owner-occupied dwellings, particularly outside municipal boundaries. Meanwhile, rented dwellings and non-residential property would probably benefit from tax reductions. There would be a significant redistributive impact, and compensation may be required if existing tax differentials have been capitalized into property values. As Hobson (1987) argues:

> An increase in effective tax rates on residential property will be borne by current property owners. Removal of tax differentials prior to capitalization simply cancels unrealized capital gains or losses. Removal of tax differentials after capitalization, however, does nothing to recapture any capital gains or losses bestowed on previous owners.[11]

Property Tax as a General Revenue Source

If the property tax were to be used by governments as a general revenue source then there are a number of equity and efficiency issues which arise, mainly as a result of the current rate structure.

(a) Vertical Equity

There remains considerable controversy as to the effective incidence of the property tax. Traditionally, this tax has been viewed as a regressive tax. This view is based on the assumption that the portion of tax which applies to structures is fully shifted forward from property owners to users of property or their customers. However, in recent years this view is increasingly being challenged. While there is general acceptance that the portion of the tax which applies to land is unshifted and borne by landowners, it is now considered that the portion of the tax accruing to structures also has the impact of a capital tax rather than an excise tax. In other words, much of the burden of the tax is believed to have remained on capital owners in the form of lower net rates of return on capital. Such a view is in fact more compatible with the reality of the property tax as a nationwide tax. Whereas a property tax imposed in a single jurisdiction would not affect the rate of return on capital, a nationwide tax could reduce the rate of return on capital invested in property. According to studies by Harberger (1962) and Mieszkowski (1972), the rate of saving is rather insensitive to changes in the rate of return to capital. Under these conditions, owners would be unable to shift part of the tax burden to tenants or users of property.[12] In the longrun, the rate of return on capital invested in property must equal rates of return on other assets of comparable risk, and so the owners of property suffer a capital loss with the imposition of the tax.

However, although the property tax is applied nationwide, it is characterized by differential effective rates. Consequently, the impact of the property tax on the rate of return will be proportional to the average rate of tax across jurisdictions. Mieszkowski (1972) refers to this phenomenon as the global effect of property taxes as distinct from the excise effects that result from the variations among local rates.

> According to the old view, the property tax on improvements were, in the long run, passed forward to tenants or users of property, leaving the rate of return to capital unimpaired. The new view comes to a radically different conclusion: the rate of return to capital is reduced by approximately the nationwide average rate of property tax. That is the substance of the global effect. It is only the excise effect that can be shifted by capital owners to other agents in the economy; for example, to tenants in rental housing units or to customers of department stores.[13]

Because the excise effects represent the difference between the local property tax rate and the national average, they generate both positive and negative burdens than can both be shifted depending on market forces. Whereas the traditional view focused on forward shifting of the property tax, proponents of the new view suggest that the excise effects are more likely to result in the backward shifting of taxes to land and immobile labour, at least in part. For instance, according to the new view of the property tax, the owner-occupant will bear the burden of the tax both as a capital owner through the global effect on the rate of return to capital and as a user of housing services through the excise effect (positive or negative) on the local cost of capital, and therefore of housing services. Furthermore, if the higher taxes are capitalized into lower land values, the benefit will not accrue to the owner-occupant but rather, the subsequent home buyer.

In the case of industrial and commercial property, capital owners also bear the burden associated with the global effect. However, the excise effects can be shifted both forwards and backwards. Firms that sell only to the local market are less likely to face outside competition and would be able to shift part of the tax burden to consumers through higher prices. On the other hand, firms that export to the national market must compete with firms who may pay lower taxes and therefore, may be unable to shift the burden to consumers. Backward shifting to landowners or to labour (to the extent that they are immobile) may help offset the excise effects of high local taxes. In the longrun, such firms would be expected to locate in a low tax jurisdiction unless the high tax area provided other locational advantages.

In summary, the new view of the property tax suggests that landowners bear the burden of the tax on land while capital owners bear the burden of the property tax in proportion to the national average rate of tax. The only excise effect is that which arises from the difference between the local tax rate and the national average. The first proposition is mostly uncontested. The second depends on the true value of the interest elasticity of saving, a question that remains unresolved. However, as Heilbrun (1983) indicates, it is the local perspective that is of interest and from this perspective

> the global effect is of no consequence .... Increasing the local tax rate will have no perceptible impact on the (progressive) global effect. Instead, it will increase the excise effect, which depends on the difference between the local tax rate and the national average. The most direct and more important result will be to raise the cost of capital locally relative to its cost elsewhere. Much of the burden of this increase will probably be passed forward to consumers of housing services and other local goods in a pattern that may well be regressive to income. To the extent that the burden is not shiftable by business, the increased cost of capital would also make

> the locality less attractive to regional or national market businesses, thus reducing private employment and weakening the local tax base. None of that could be thought as desirable.[14]

It is important to point out that irrespective of whether one adopts the traditional or the new view of the property tax, its incidence is likely to be regressive over the lower-income ranges. Individuals in the low-income ranges tend to spend a greater proportion of their revenue on housing services. On the other hand, some of these individuals may also receive a large fraction of income from capital (for example, pensioners). This would warrant the use of credits or exemptions to alleviate the regressivity of the tax in the lower-income groups, perhaps in the form of a property tax credit against the income tax or an assessment based credit. The income tax credit offers the clear advantage, from an equity perspective, of a direct link between the tax credit provided and income as a indicator of ability to pay. However, there are some problems such as the fact that the federal government would have to approve the credit program, the difficulty in choosing the appropriate income definition (for example, gross, net or taxable; family income *versus* individual income) to calculate the value of credit to be provided to taxpayers; and the difficulty in predetermining accurately the cost of the program. The advantages of graduated assessment-based credits are that the costs involved would be determined more accurately.

The Non-residential Property Tax

One of the main criticisms of the property tax has been the fact that as implemented, it is highly distortionary. The property tax creates distortions, at several levels: (1) the differential taxation of business property *versus* residential property will cause resources to be misallocated inter-sectorally; (2) the differential taxation of apartment buildings *versus* single family dwellings will cause resources to be misallocated inter-sectorally; and (3) the interjurisdictional rate differentials will cause the interjurisdictional misallocation of resources. Studies indicate that the non-residential property tax is an important contributor to the variations in effective tax rates on capital within the manufacturing and non-manufacturing sectors of the Canadian economy.[15]

In most provinces, the effective tax rate on residential property is a considerably lower rate than that on nonresidential property. This is accomplished by applying a differential rate, or different assessment practices. This approach reflects the prevailing opinion that businesses should bear a heavier tax burden because of their greater ability to pay. However, as indicated above, this rationale is questionable. This approach also ignores the ability of businesses to shift the burden of taxes either forward onto consumers or backwards onto labour in a pattern which may be regressive overall.

There is no economic criterion which can be used to justify higher effective property tax rates which generally apply to non-residential property in Canada. In fact the opposite situation may be easier to justify.

> Viewed as a benefits tax, effective tax rates should be higher on residential rather than nonresidential properties since benefits, especially people-related benefits, accrue largely to residents not businesses. On ability to pay grounds, there is no reason to presume that the value of property owned is correlated to ability to pay. Given a positive income elasticity of demand for housing services, however, there

> may be some correlation between the value of residential property owned and ability to pay.[16]

Furthermore, the application of split rates or occupancy taxes are inefficient in that they may induce the misallocation of resources (land and capital) among different uses. Estimates of effective tax rates on capital suggest that the non-residential property tax is an important contributor to the variations in tax rates within both the manufacturing and non-manufacturing sectors of the Canadian economy. According to some experts, the efficiency costs associated with property taxation would be lowest if effective non-residential property tax rates were lower than the residential rates. Indeed, some argue that a higher tax rate should apply to the less mobile factor, in this case owners of residential property.[17] Finally, a residential property tax may be advocated as an indirect way of taxing imputed rent.

Another important issue concerning the non-residential property tax is that of tax exporting. Some commentators have found property tax exporting to be a significant occurrence among Canadian jurisdictions. Indications are that the non-residential property tax is, in many cases, shifted to consumers or owners of the factors of production residing outside the taxing jurisdictions. This can be done either through changes in the terms of trade or as a result of lower rents paid to non-resident capital owners. While tax exporting may be politically attractive, it can only be rationalized to the extent that local services enter the production process. This condition would only apply in certain cases and is unlikely to exist in the context of people-related services.[18]

There are three undesirable effects of tax exporting that should be considered. First, the ability to export the tax burden is very much dependent on the community's (or more precisely, their businesses') control over its terms of trade with others. It can be expected that the attitude toward tax exporting will be directly related to whether a community is a net tax exporter or importer. Second, Ballantine and Thirsk (1982) suggest that there may be a correlation between average income and tax exporting rates. To the extent that such a pattern exists, there would be an implicit income transfer from low-income communities to high-income communities that effectively counteracts the impact of transfer programs with redistribution objectives. Finally, as Thirsk (1982) indicates, taxation without representation leads to the inefficient over-provision of public goods and services. The last two elements clearly argue in favour of lower non-residential property tax rates.

A further issue to consider in setting non-residential property tax rates is whether lower rates will provide a location incentive.

> The potential for property tax competition among jurisdictions is evident and this is often cited as yet another source of inefficiency resulting from property taxation. Yet, to the extent that the location of industry generates employment locally, such inducements may be justified on efficiency grounds in jurisdictions with unemployment. If unemployed workers collect welfare payments supported out of local property tax revenues, then increased local employment lessens the demands being made on the existing property tax base permitting further rate reductions.[19]

Property Tax Reforms

The areas for potential property tax reform are related to the current rate structure rather than to the administration of the tax. In this regard, it should be determined to what extent

the government will rely on the property tax as compared to other taxes as a source of revenue. As a percentage of aggregate municipal and provincial revenue, the importance of the property tax as a source of revenue is decreasing over time. A more equitable and more efficient property tax could potentially be used to a greater extent as a means of increasing revenue, or alternatively, compensating for a reduction in the sales tax rate.

The case of the property tax as a benefits tax would eliminate the incidence and efficiency issues related to this form of taxation. Rate differentials would be a direct reflection of benefits received. It should be noted that, in practice, it may often be difficult to ascertain the benefits received by people in different circumstances, or to distinguish between people-related and property-related services. Even if the property tax were to remain a general revenue source, there are a number of improvements that should be considered both on grounds of efficiency and equity.

Based on current knowledge of property tax incidence the only form of property tax credit justifiable is one aimed specifically at reducing the regressivity of the tax in the low-income ranges. This could be accomplished either with a property tax credit against the income tax or through an assessment based credit. The advantage of the former is its direct link to income as an indicator of ability to pay while the advantage of the latter is the fact that the program would be provincially administered and that it would be easier to assess and predict the costs of the program.

There is no economic rationale to justify higher effective property tax rates on non-residential property as compared with residential property. In fact, the opposite situation may be easier to condone. As a benefits tax, a higher rate on residential property would be desirable to the extent that these property owners benefit to a greater degree from the services provided, particularly people-related services. There is no reason to believe that businesses should pay a higher rate because of their greater ability to pay, particularly since these property owners are able to shift their tax burdens. The differential rate system in itself generates efficiency costs from the induced misallocation of resources (land and capital) between sectors. Furthermore, the non-residential property tax has been shown to contribute to the wide variation in effective tax rates on capital between industries within the manufacturing and non-manufacturing sectors. On the other hand, the residential property tax may even out rate differentials between the corporate sector and non-corporate sector by counteracting the preferential treatment of owner-occupied housing under the personal income tax.

Higher rates on non-residential property taxes simply exacerbate the efficiency costs of the property tax. Economic reasoning suggests that the more mobile factors should be taxed at a lower rate. Moreover, the issue of tax exporting, as related to the non-residential property tax, involves undesirable effects such as the inefficient over-provision of local services and the implicit transfer of income from low-income to high-income communities. Finally, the possibility of providing location incentives through lower non-residential tax rates should be considered.

Notes

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Chapter X

Tax Related Transfers: Equalization Payments[1]

1. Introduction

Ever since the establishment of the Canadian nation in 1867, the federal government has provided grants and subsidies to the provincial governments to assist them in fulfilling their constitutional responsibilities. Generally, these payments have not been calculated as a uniform amount per capita. Rather, they have been calculated to provide higher than average per capita funds to the poorer provinces. There has been a recognition that each provincial government has to provide a certain standard of services, and that provinces with lower than average incomes require special assistance to enable them to do this. Since the federal government has generally raised more of its revenue per capita from Canada's wealthier provinces, these payments have effectively been a transfer from the richer regions of the country to the poorer regions of the country.

Prior to 1957, payment levels were negotiated as dollar amounts, but since 1957 payments have been geared to specific formulae. The particular formula chosen for the calculations has been changed from time to time. The first formula was used over the period 1957-1967, a second formula was introduced in 1967, and a third formula was adopted in 1982. Certain elements have been common with these three formulae, but the changes in each of 1967 and 1982 were of major significance.

In 1868, grants and subsidies from the federal government constituted 55 per cent of aggregate provincial revenues. By 1930, this figure had fallen to 10 per cent, and the federal payments were failing to achieve their purpose. The Rowell-Sirois Report of 1939 criticized the system then in use and recommended:

> that the "chaotic and illogical" statutory grant system be replaced with national adjustment grants to be made to the poorest provinces so that they could provide

> public services of average quality without placing an undue tax burden on their citizens.[2]

The Commission advocated that a new grant system be implemented and that it be reviewed every five years so that adjustments could be made in accordance with changing economic circumstances. As it suggested in its report, the Commission believed that three provinces were able to provide Canadian-average levels of services without federal grants: Ontario, British Columbia and Alberta. The Commission did not recommend any specific formula for the provision of federal grants to the other provinces. Rather, the Commission's approach was that each province's fiscal needs should be examined separately, with an analysis of both expenditure needs and revenue capabilities.

The Commission recognized that the need for federal grants to the provinces would depend upon the particular responsibilities allocated to the provincial governments. For example, while recognizing that education, welfare, and certain development expenditures were constitutionally a responsibility of the provinces, the Commission did recommend that the federal government take over old age pensions and unemployment insurance.

In response to the Commission's report, some provinces saw a danger in the proposed centralization of fiscal responsibility in the hands of the federal government. In fact, the concept of some standard process or formula for calculating federal-provincial grants was not accepted until 1957. Rather, federal-provincial negotiations resulted in various combinations of grants and tax-sharing over the years prior to 1957. The personal and corporate income tax were the focus of considerable debate in regard to federal-provincial tax-sharing, but there was no explicit linkage between the taxes a province levied on the one hand and the grants that the province received on the other hand. In 1957, a new program of equalization payments was instituted, geared to each province's tax revenues, and significant changes in the equalization payment formula were made in 1967 and 1982.

The equalization payment concept is now permanently enshrined in Canada's fiscal arrangements. The Constitution Act, 1982, specifically guaranteed that equalization payments will henceforth be made to enable each provincial government to provide comparable levels of services. Poor provinces will not have to establish higher than average levels of taxation in order to generate the necessary revenues. Poorer provinces will have to establish only those levels of taxation that are reasonably equivalent to the levels in the richer provinces, and the revenue gap will be filled by equalization payments. The Constitution Act, 1982, explicitly states that:

> Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Nevertheless, the choice of formula for calculating these equalization payments remains open to debate. Courchene (1984) has emphasized four basic questions that should be considered in the analysis and evaluation of any equalization formula:

1. What revenue (or expenditure) categories will be eligible for equalization?

2. How will provincial fiscal capacities (deficiencies and excesses) be defined?

3. What is the standard for equalization? That is, up to what level will provincial revenues be equalized?

4. How will the program be funded?[3]

2. The Rationale for Equalization Payments

The rationale for equalization payments involves the objective of efficiency as well as the objective of equity. To some degree, and depending upon the economic circumstances, these two objectives may conflict in the choice of the formula for equalization and the appropriate volume of equalization payments.

The equity objective is based upon the belief that all Canadian residents should have access to comparable government services in return for comparable levels of taxation, regardless of where those residents live. There are many reasons why per capita incomes may differ among provinces. Of particular importance are situations where some provinces have a greater value of resources per capita than do other provinces. In such situations, the residents of resource-rich provinces will likely be the beneficiaries of higher than average levels of provincial government services, and/or lower than average levels of taxation. Meanwhile, residents of poorer provinces will suffer lower than average levels of provincial government services and/or higher than average levels of taxation. In view of this, the concept of equalization is intimately linked with the concept of resource rents, and with the equity objective of sharing resource rents among the provinces.

It is important to note that over time, the value of a province's resource rents may change significantly. In particular, the price of resource-based products may oscillate, and the discovery of new resource deposits may abruptly increase a province's fiscal capacity. It is also important to note that there is no automatic relationship between the value of resources in a province and the value of resource rents captured by the government of that province. The relationship may vary over time depending upon the policies of the provincial government in regard to resource taxation and in regard to the alternative ways of extracting resource rents. Chapter IX has discussed these matters in the context of factor specific taxes. Resources may also impact a province's fiscal capacity indirectly by raising the incomes of individuals and corporations. Having higher than average personal and corporate incomes, the resource-rich province may receive greater per capita revenues from the PIT and CIT, as well as from its other taxes, like the sales tax.

The equity objective does not require the establishment of identical tax rates across all provinces or the establishment of identical levels of services across all provinces. It may be that a certain province wishes to provide higher levels of service with higher levels of taxes, while another province may wish to provide lower levels of service with lower levels of taxes. Consequently, an equalization formula based on the equity objective would not necessarily focus on actual tax revenue per capita in each province. Rather, the equalization formula could focus on the hypothetical tax revenue that would be generated in a province if that province had chosen to impose a certain level of taxes and if that province had a certain tax base. That hypothetical revenue figure could be based upon various alternative standards, such as the average rates and bases across all provincial governments, or the average rates and bases of a subset of provinces.

From the perspective of efficiency, a central concern is that capital and labour should make their location decisions in response to productivity considerations. It would be inappropriate for equalization payments to be so high as to alter the free market allocation of capital. Labour and capital should be paid their marginal products, and factor mobility should result in these marginal products being the same throughout the nation. Changing economic circumstances could require that labour and capital shift out of a depressed region, and equalization payments should not be structured so as to impede that shift. Consequently, from the perspective of efficiency, significant regional economic disparities would not automatically be a reason for equalization payments. In fact, an equalization program could introduce distortions in the market and could be a cause of inefficiency. Efficiency may also be impeded if provinces have different degrees of progressivity in their taxes. For example, a wealthy individual or corporation may be motivated to shift from one province to another not on the basis of economic efficiency, but rather because it can reduce its tax burden by relocating.

With the efficiency objective, as well as the equity objective, it is important to note that any one province may decide to have higher than average taxes in order to provide higher than average benefits. This need not hamper efficiency if individuals and corporations can see that their higher taxes do in fact provide higher benefits. Efficiency will be attained in this regard if Net Fiscal Benefits (NFBs) are identical for all individuals and corporations across all provinces.

3. The 1957-1967 Period

In 1957, a federal-provincial equalization program based upon a specific formula was established for the first time. The formula focused on three taxes: (1) personal income taxes, (2) corporate profits taxes, and (3) succession duties (estate taxes). Under the formula, each province's equalization payment would be the amount required to raise its per capita yield from these three taxes up to the average yield in the two richest provinces (Ontario and British Columbia).

In addition to this formal equalization program, the federal government also introduced a program of Atlantic Provinces Adjustment Grants and Newfoundland Additional Grants. These supplementary programs were based upon the general recognition that the provincial governments of the Atlantic provinces faced particularly low tax revenue potential in other types of taxes besides the three that had been included in the equalization payments formula.

The equalization objective was also supported through the concept of federal cost sharing for specific provincial programs. In 1958, for example, the federal government promised to pay a share of each province's hospital insurance program. The particular formula chosen was that each province would receive 25 per cent of the national average per capita cost plus 25 per cent of its own per capita cost. Under this program, a poor province might receive a larger percentage of its total costs than would a rich province.

In 1962, natural resource taxation was added to the three taxes mentioned above as the basis for equalization payments. Specifically, 50 per cent of the total provincial revenues from natural resources would be taken into account in the equalization payment calculations. Another change in 1962 was to calculate equalization not on the average of revenues in the two richest provinces, but rather on the national average of revenues. The former change

increased the level of equalization payments while the latter change reduced the level of equalization payments.

4. The 1967-1982 Period

In 1967, the *Fiscal Arrangements Act* introduced a new equalization formula. Sixteen types of taxes were now included in the equalization formula. All revenue categories were included fully in the formula (as opposed to only 50 per cent of resource revenues in the period 1962-1967 and in the period since 1982). This new formula was referred to as the Representative National Average Standard (RNAS). The provinces were guaranteed per capita revenues equal to the all-province average for certain specified revenue categories. These revenue categories were chosen to be representative of provincial taxing practices.

In 1972, three new taxes were added to the formula: (1) medicare premiums, (2) hospital premiums, and (3) race track taxes. In 1973, a portion of local property taxes was also brought into the formula, specifically that portion designated for school purposes (approximately one-half). In 1974, faced with the rapid escalation of world energy prices, the federal government announced that energy royalties and revenues would no longer be included fully in the equalization formula. The federal government attempted to divide provincial energy revenues into "basic revenues" that were not a direct result of the international energy crisis, and "additional revenues" that were a direct result of the international energy crisis. Only the "basic revenues" were to be included in the formula.

By 1977, the number of taxes included in the equalization formula had increased to 29. This increase was principally the result of dividing some of the previous kinds of taxes into separate components. This created greater precision in regard to the calculation of Representative National Average Standards. In 1977, the proportion of non-renewable resource revenues included in the equalization formula was set at 50 per cent.

In 1977, a related development was a change in the arrangement under which the federal government agreed to share the cost of certain provincial programs. Prior to 1977, each province received a federal grant approximately equal to 50 per cent of its expenditures on medicare, hospital insurance, and post-secondary education. After 1977, these "established programs" were to receive block funding from the federal government. This block funding was to consist of a cash grant plus a portion of the federal government's personal and corporate income tax. In practice, this has meant that the federal contributions are no longer 50 per cent of each province's costs.

In 1981, the federal government decreed that no province could receive equalization payments if its personal income per capita exceeded the national average personal income per capita. This change was instituted in order to prevent Ontario from qualifying for equalization payments under the formula as it existed.

5. The Period 1982 to the Present

In 1982, the federal government instituted a basic change in the equalization formula. Henceforth, the new standard for calculating equalization payments would be a Representa-

tive Five-Province Standard (RFPS). For each revenue source, the average tax rate for all provinces is applied to the average per capita base of the five provinces chosen as representative of all the provinces. For each revenue source, the equalization payment to a province is the amount necessary to raise that province's hypothetical revenue that would result from applying the national average tax rate up to the level obtained by applying that national average tax rate to the average per capita base of these five provinces. The five provinces chosen were Ontario, Quebec, British Columbia, Saskatchewan, and Manitoba. The formula for RFPS equalization for each revenue source is as follows:

$$\begin{array}{c}\text{Equalization} \\ \text{per} \\ \text{capita}\end{array} = \begin{array}{c}\text{national} \\ \text{average} \\ \text{tax rate}\end{array} \left(\begin{array}{c}\text{the five provinces'} \\ \text{base per} \\ \text{capita}\end{array} - \begin{array}{c}\text{province's own} \\ \text{base} \\ \text{per capita}\end{array} \right)$$

The number of revenue sources included in the formula was raised to 32. The additions included property taxes related to municipal activities as well as property taxes related to schools, and municipal revenues from the sale of goods and services. Oil and gas revenues were classified into several separate components.

Under this new formula, if any province increases its tax rate for any tax, then the national average tax rate for that tax increases. Under the RFPS formula, equalization payments will then increase to the provinces that are "have-not" in respect of that tax base. Conversely, if any province decreases its tax rate for any tax, then equalization payments will decrease for provinces that are "have-not" in respect of that tax base.

In order to provide stability in the volume of equalization payments received by each province, a new provision was introduced. Provinces will not receive less than a stipulated percentage of their equalization payment in the preceding year. This stipulated percentage depends upon the province's fiscal capacity, with the poorest provinces never receiving less than 95 per cent of their entitlement for the preceding year.

6. Equalization Payment Reforms

The above discussion suggests that the calculation of equalization payments will no doubt change from time to time. In particular, certain types of revenue may be added to the formula. In some cases, revenue sources may be divided into separate components in order to provide greater precision. Of most importance, resource rents may be treated differently as time passes. In particular, significant changes in the market prices of resource-related products and the discovery or depletion of resources may impact provincial attitudes towards the equalization formula. Negotiations over an appropriate equalization formula will often be motivated strongly by changes in the volume and distribution of resource rents across the country, and by changes in the actions of provincial governments to capture those resource rents.

Consequently, the calculation of equalization payments will no doubt be an important subject for federal-provincial negotiation indefinitely. Closely linked to the equalization payments are the arrangements through which the federal government agrees to share certain provincial government expenditures. Changes in these arrangements will likely impact

provincial revenue needs, with the poor provinces being affected differently than the rich provinces. Consequently, changes in the federal government's cost sharing of provincial expenditures will also likely result in provincial demands for changes in the equalization formula. As we shall see in Chapter XII, a concern of current importance is how a possible new federal-provincial value-added tax would be dealt with in the equalization formula.

Notes

1. This chapter is based largely upon Thomas J. Courchene, *Equalization Payments: Past, Present and Future* (Toronto: Ontario Economic Council, 1984).
2. Richard Bastien, *Federalism and Decentralization: Where do we Stand?* (Ottawa: Government of Canada, 1981), pp. 10-11.
3. Courchene, pp. 8-9.

PART III

THE PROCESS AND IMPLICATIONS OF FEDERAL TAX REFORM

Chapter XI

The 1987 Proposals

1. Introduction

The 1987 White Paper on Tax Reform indicated the Canadian government's intention to implement sweeping changes to the personal, corporate, and federal sales tax systems. A combination of factors led to the resurfacing of tax reform as a major issue in Canada. One concern was the gradual but significant shift in the relative burden of taxation from the CIT to the PIT. As Table 11.1 indicates, the percentage of total federal revenue obtained from the CIT has fallen from 22.9 per cent in the early 1970s to only 15.6 per cent in 1987-1988; while the percentage of total federal revenue obtained from the PIT has risen from 57.6 per cent to 65.1 per cent over the same period. The federal reform proposals were aimed at redressing the balance. We should note, however, that the post-reform revenue projections for 1991-1992 estimate that the CIT will still raise only 17.2 per cent of total federal revenue, while the PIT will raise 62.9 per cent. Much of the federal discussion – and hence much of this chapter – is based upon comparisons of what could happen to future revenue if reform did not occur, with what could happen with reform. From this perspective the reform appears to have a substantial impact. As Table 11.1 reminds us, however, this impact will not even shift the relative CIT and PIT shares in total revenue back to the early 1970s proportions. In this sense, the reform is not nearly as substantial as the federal government has sometimes suggested.

Another central objective was to remove many low-income people from the tax rolls by raising basic personal exemptions. Once again, the reform significantly altered this situation compared with the outcome that would have occurred without reform. Yet, compared with the situation of earlier years, the changes are not as dramatic. Inflation and the non-indexing of personal exemptions and tax brackets raised many low-income people into a taxable situation, where they had not previously been taxed. In this sense as well, federal reform seeks to

redress changes of recent years, and its impact is not as dramatic if compared with the situation ten to twenty years ago.

The non-indexing of tax brackets also means that the federal reform will carry within it the process for significant future reversals of the current reform objectives. Inflation will continually shove tax payers into higher tax brackets and will likely increase the percentage of total revenue obtained from the PIT. Without future reforms, there will be a gradual movement towards a PIT that is proportional rather than progressive, as more tax payers shift into the upper-income tax bracket.

Table 11.1
Structure of Main Federal Tax Revenues

Fiscal Periods	Personal Income Tax	Corporate Income Tax	Federal Sales Tax	Total of Personal, Corporate and Sales Taxes
		(per cent)		
Historical				
1971-72 to 1975-76	57.6	22.9	19.5	100.0
1976-77 to 1980-81	59.4	23.3	17.3	100.0
1981-82 to 1985-86	64.6	19.0	16.4	100.0
Current Year Projections				
1987-88	65.1	15.6	19.4	100.0
Projections for Stage One of Tax Reform				
1991-92	62.9	17.2	19.9	100.0

Note: Details may not add due to rounding.

Source: Michael H. Wilson, *The White Paper: Tax Reform 1987* (Department of Finance, Canada, 1987), p. 33.

For some time now, the government has been concerned with the inadequacies of the manufacturers' sales tax. Several alternatives had been considered throughout the years, with a multi-stage sales tax emerging as the most appealing. However, attempts to work out the practicality of implementing such a tax eventually led the government to the conclusion that the reform of the MST could not be achieved independently from the rest of the system. The economic ramifications of a multi-stage sales tax are such that it should be made consistent and compatible with the rest of the system (that is, the personal and the corporate income tax), and the revenue potential of the new sales tax may enable a shift in the major revenue sources.

These developments, combined with the ambitious, high profile 1986 tax reform program in the United States, provided more than enough incentive to undertake a comprehensive and integrated reform of our corporate, personal, and sales tax systems, as proposed by Finance Minister Michael Wilson.

When comparing tax reform policies in the United States and Canada several interesting similarities, as well as important differences, are revealed. Both countries sought to broaden the tax base by cutting back on permissible deductions and special concessions. Both have introduced a new minimum tax provision to ensure that the wealthy do not completely avoid paying tax by using loopholes. The additional revenue raised will result in a significant decrease in statutory tax rates. Nevertheless, full taxation of capital gains in the United States contrasts sharply with the Canadian capital gains exemption. Reductions by the United States in the tax deductible limits for pension contributions contrasts sharply with Canadian plans to increase these limits. The proposal by the Canadian government that a new multi-stage sales tax be introduced finds no equivalent in the United States. Finally, while tax reform in the United States shifts a major share of the tax burden from the personal to the corporate income tax, it is still too early to predict the ultimate weight that will be assigned to these taxes in Canada. However, it is here that the implementation of a broad-based sales tax is expected to play a major role. The Federal-Provincial Tax Collection Agreements create an additional complexity for Canadian tax reform. While Canadians may gain valuable insights from the debate in the United States, indications are that the approach to tax reform may be significantly different here.

These issues are of paramount importance to provincial governments. For instance, most provinces have a tax collection agreement with the federal government whereby the latter collects personal and corporate income tax revenue for certain provinces as long as these provinces accept a common tax base. Any broad reform to these tax bases will automatically alter the rules, rates, and revenue of the provincial taxes. Likewise, any major change to the federal sales tax is certain to have an impact on provincial retail sales taxes. This chapter looks at the basic elements of the federal tax reforms with respect to the personal and corporate income taxes, as well as the manufacturers' sales tax, and discusses some of the implications from the provincial perspective.

2. The Federal Tax Reform

The federal government's reforms have involved significant adjustments to the main components of the tax system: the personal income tax (PIT), the corporate income tax (CIT), and the manufacturers' sales tax (MST). The stated objectives are to raise the necessary revenue to pay for publicly funded programs in a way that will be fairer to all Canadians and in a way that will support economic growth. By removing specific preferences, broadening the tax base, lowering tax rates, and replacing exemptions with tax credits, the government intends to increase incentives to work and invest, to remove obstacles to growth and job creation, and ensure that the tax burden will be distributed more equitably.

Tax reform was seen as two stages. The first stage involved the reform of the individual and corporate income tax systems. Sales tax reform was to be implemented later in the second stage. Here the objective was to replace the manufacturers' sales tax with a broad-based multi-stage sales tax. The government indicated its preference for a national sales tax in

collaboration with the provinces, although it intends to proceed with the new sales tax even if provinces choose not to participate.

As a result of the reforms, it seems that the federal tax mix will be adjusted in favour of increased reliance on indirect taxes with relatively less reliance on direct taxation. As far as direct taxation itself is concerned, the balance will shift away from personal income tax towards corporate taxation. With pressures to move in line with recent reforms in the United States, and to be consistent with the general direction of fiscal reform in other countries, federal tax reform in Canada will result in broader, more comprehensive direct tax bases and lower rates. This will provide fewer deductions, and it will reduce the reliance on the tax system to achieve specific allocative and distributive objectives. However, when compared to the United States, Canada has few significant fiscal holes to plug. Therefore, there is less scope to broaden the federal direct tax bases and correspondingly less scope to lower rates substantially without major revenue losses. It should also be noted that the removal or reduction of Canadian tax incentives for new investment could have a negative impact on economic growth, unmatched by the positive impact of lower average corporate tax rates.

The anticipated increased reliance on indirect taxation has three principle motivations in Canadian tax reform. First, since ostensibly "revenue-neutral" tax reforms necessarily involve trade-offs in revenue sources, and with every indication that direct tax rates and revenues will fall, a broadly-based indirect tax provides an efficient alternative revenue source. Second, the heavily criticized, highly distortionary and inefficient federal manufacturers' sales tax is to be dismantled and replaced by a more properly designed tax of the value-added variety. Third, modern tax reform is being driven to a large extent by the policy position that it is preferable to tax consumption as opposed to income; or at least not to tax savings and investment. Such a provision can be conveniently incorporated in a broadly-based indirect tax structure.

Provinces will face a challenge as a result of federal tax reform because of the possible change in tax mix (the balance between direct and indirect taxes), as well as the impact on total provincial revenue. Because provincial income tax revenues are calculated as a fraction of federal taxes paid by provincial residents, a cut in personal tax rates at the federal level will reduce provincial revenues. At the same time, corporate tax reforms may increase provincial revenue. On the other hand, increases in federal indirect taxes (such as a nonrevenue-neutral change involving the replacement of the MST with a multi-stage sales tax that raises more revenue) will not necessarily generate corresponding increases in provincial revenues. A key issue will be whether provinces opt for the national sales tax variant. If they choose not to, an impact will still be felt at the provincial sales tax level. Currently, provincial retail sales taxes (RST) apply to the retail value which has included the MST. The anticipated change to a broader federal sales tax at a substantially lower rate could reduce relative prices of goods as opposed to services, and so could result in lower RST revenue for the provinces. Overall, changes in the tax mix at the federal level will tilt more towards indirect taxes, thus reducing provincial revenues and forcing provinces to make compensating adjustments to their own tax systems.

3. Personal Income Tax Changes

As already mentioned, the approach to personal income tax (PIT) reform in the United States has been to broaden the base in order to bring the PIT more in line with comprehensive income taxation. Such an approach was recommended for Canada in 1967 by the Carter Commission on Taxation, and Canada's 1971 tax legislation adopted some of the Carter Commission proposals for comprehensive income taxation. However, since 1971 the overall trend underlying the major changes in the Canadian PIT has been away from base broadening. The taxation of comprehensive income has been replaced largely by a consumption tax approach. Indeed, the 1984 and 1985 budget proposals to increase the tax deductible contributions to registered retirement savings plans, and the 1985 budget measure to phase in a $500,000 lifetime capital gains exemption, together with the current treatment of owner-occupied housing, would have brought the PIT even closer to a consumption (rather than an income) base tax.

In implementing its objectives of a broader base and lower rates, it appears that the government is stepping back from the consumption tax measures described above. The major personal income tax changes can be summarized as follows:

1. The reduction of the ten income tax brackets to three, with the top rate on taxable income over $55,000, being reduced from 34 to 29 per cent. Taxable income between $27,500 and $55,000 will be taxed at a marginal rate of 26 per cent. The marginal rate on the first $27,500 of taxable income will be 17 per cent.

2. The substitution of essentially all personal exemptions by tax credits. The value of the tax credit is to be the same for all taxpayers regardless of their marginal tax rate. The credit is to be subtracted directly from tax owing rather than from income as was the case with exemptions. Because the value of exemptions increases in relation to marginal tax rates, the proposed tax credits will result in a greater tax saving for lower-income tax payers and a lesser tax saving for higher-income taxpayers, as compared with current exemptions.

3. The conversion of certain deductions to tax credits at a rate of 17 per cent. The pension income deduction; tuition fees and education deduction; medical expense deduction; charitable donations deductions; and Canada Pension Plan and unemployment insurance contributions deductions will undergo this conversion. In this case as well, the credit approach generally favours lower-income taxpayers, although charitable donations above $250 are creditable at the top marginal rate of 29%.

4. A gradual increase in the portion of capital gains that are subject to tax from one-half to two-thirds to three-quarters, with capping of the capital gains exemption at $100,000. However, the cumulative exemption for capital gains realized on the sale of family farms and small business corporations will continue to be $500,000, and capital gains on principal residences remain fully exempt.

5. The reduction of the dividend tax credit and the elimination of the $500 employment deduction and the $1,000 investment income deduction. The reduced dividend tax credit is to accompany the reduced statutory corporate tax rates.

6. As a further base-broadening effort, the phase-in of the new RRSP and RPP limits will be slowed down. The increases in the dollar limits for deductible contributions would reach the maximum limit of $15,500 in 1995 instead of 1991 for registered retirement savings plans and 1994 instead of 1990 for money purchase employer-sponsored plans.

7. The reduction in the amounts that can be claimed on account of entertainment, car expenses, and home office expenses.

8. A number of tax shelters will be phased out, such as special provisions for multiple unit residential buildings (MURBs).

Changes to the personal income tax system are expected to reduce the overall PIT burden by $11 billion over the 1989-1994 period. Tax liabilities would be reduced for 8.9 million households, over 80 per cent of the total, and about 850,000 lower-income taxpayers would be dropped from the tax rolls. These changes are mainly a consequence of the conversion of personal exemptions to tax credits, which are of more value to low-income taxpayers because of lower marginal rates. For the 1.5 million taxpayers who face PIT increases, the effect of cutbacks in tax shelters, of reductions in the dividend tax credit, and of the limits on the use of capital gains exemptions, exceed the benefits of marginal tax rate reductions. Generally speaking, taxpayers with a substantial portion of gross income derived from investment income or self-employment, are more likely to face tax increases whereas those whose primary source of income is wage or pension income will probably see their tax liability reduced. Overall, the changes are expected to reduce the variation in average tax rates for taxpayers within the same income groups. While these changes have been anticipated in federal government documents, nevertheless, a 1988 study by Allan Maslove has cast doubt upon this. Maslove's findings suggest "no appreciable change in dispersion, so that overall, one cannot conclude that any significant change in horizontal equity has occurred as a result of tax reform."[1]

As Table 11.2 indicates, the residents of all provinces will benefit from the reduction in total federal income tax collections, compared with the projected tax collections under the pre-reform system. The greatest reductions are expected to occur in the Atlantic region with Newfoundland residents likely to benefit from relatively greater income tax reductions than taxpayers elsewhere. The percentage change in federal tax collections in the remaining provinces is in the average range of -4.2 to -4.8 per cent. Saskatchewan is the exception with a relatively lower rate of -3.6 per cent. Newfoundland, Prince Edward Island, Manitoba, and Nova Scotia will have the highest percentages of tax filers becoming non-taxable. The Atlantic provinces also have the largest ratios of tax filers with a decrease in tax relative to those with an increase.

In nine out of ten provinces that have personal income tax collection agreements with the federal government, the reduction in federal tax collections automatically means reduced provincial PIT collections. The residents of provinces who benefit from the largest percentage reductions in federal tax liabilities will also likely benefit from the largest percentage reductions in provincial tax liabilities. Two separate elements are at play. On the one hand, residents in the Atlantic provinces will benefit more than residents in other provinces from federal PIT measures that reduce the federal tax payable and therefore, the provincial tax payable. On the other hand, these provinces also have the highest PIT rates as a percentage of basic federal tax which translates into greater reductions in provincial PIT payable on equivalent basic federal tax payable. The residents of the Atlantic provinces will have more after-tax income to consume or save as a result of federal PIT reform. However, the governments of these provinces will have to face greater reductions in PIT revenues. It is estimated that the direct impact of personal income tax reform on provincial government revenues, for all provinces except Quebec for the 1990 taxation year, would be a $880 million reduction.

Table 11.2
The Regional Impact of Federal Personal Income Tax Changes

Province	Individual taxfilers becoming non-taxable		Individual taxfilers with tax		Change in total federal tax collections
	(000)	(%)	decrease (000)	increase (000)	(%)
Newfoundland	25	10.6	190	30	-6.3
Prince Edward Island	6	10.0	50	8	-5.5
Nova Scotia	30	7.1	355	55	-5.6
New Brunswick	25	6.4	280	45	-5.8
Quebec	210	6.3	2,690	510	-4.6
Ontario	295	5.6	4,160	825	-4.2
Manitoba	50	8.5	460	95	-4.8
Saskatchewan	30	6.0	390	90	-3.6
Alberta	70	5.4	1,040	210	-4.2
British Columbia	95	6.1	1,280	235	-4.5
All Canada[1]	843	6.1	10,960	2,120	-4.4

1 All Canada total includes residents in the Yukon and Northwest Territories, taxpayers living outside Canada and those subject to tax in more than one jurisdiction. Because of small sample sizes, separate estimates are not shown for individuals in these categories.

Source: Department of Finance, *The White Paper: Tax Reform 1987*, p. 43.

4. Corporate Income Tax Changes

Capital is highly mobile between the United States and Canada, and so it is not surprising that recent tax reforms in the United States are of great interest to Canada. The direction of tax reform, as revealed by legislation in the United States and by legislation put forth since the 1985 Department of Finance discussion paper on Canadian Corporate Tax Reform, is similar in the two countries. Corporate tax reform in the United States has taken the approach of broadening the tax base and lowering corporate tax rates from 46 to 34 per cent. The base has been broadened primarily by removing the investment tax credit and by substantially expanding the role of the minimum corporate tax (a tax that does not exist in Canada). What is significant for Canada is that the corporate tax tightens up the foreign tax credit by limiting the ability of the corporation to aggregate foreign profits across sources. The U.S. research and development (R&D) tax credit has been extended but at a reduced rate, and the qualifying criteria have been tightened. Some business expenses are now only partially deductible. The effect of these changes will be to increase U.S. corporate tax revenues by $120 billion over the 1986-1991 period. This large increase will be used to reduce overall personal income tax rates. It should be noted that the corporate tax system in the United States is "classical" in that there is no dividend tax credit or any other means of relieving the double taxation of dividends.

The proposals contained in the May 1985 Canadian Federal Budget and the accompanying discussion paper entitled *The Corporate Income Tax System: A Direction for Reform* predated the reforms in the United States, yet are remarkably consistent with those reforms. The proposals in the budget paper were:

1. the removal of the investment tax credit except for that on research and development;
2. the elimination of the 3 per cent inventory allowance;
3. a significant reduction in accelerated depreciation with a proposed maximum 25 per cent rate for capital cost allowance to replace the 2-3 year straight line write-off for manufacturing and processing equipment; and
4. a reduction in the standard federal rate from 36 to 29 per cent, 30 to 23 per cent for manufacturing and processing, and 15 to 11 per cent for small businesses.

As these proposals suggested, the thrust of corporate tax reform in Canada has been towards broadening the corporate tax base and lowering the rate. Although the Canadian reforms were initially designed to be revenue neutral at the corporate level rather than revenue enhancing as in the United States, the White Paper proposals suggested that corporations will contribute a greater share of tax revenues in Canada as well. However, the Canadian reforms propose the virtual elimination of accelerated depreciation, a provision that has been left largely untouched in the United States.

After the Canadian proposals were made, the reforms in the personal and corporate income taxation in the United States were enacted. These reforms included significant reductions in the marginal personal tax rates at all income levels with, as stated, the revenue loss made up from corporation income taxes. The Canadian federal government believed that such reductions demanded a response in Canadian personal income tax rates, a belief shared by many taxpayers. The problem is that neither the personal nor corporate income tax bases in Canada provides the scope for base broadening that existed in the United States. This has meant that a significant portion of the revenues required will be obtained by some form of national sales tax.

The corporate income tax changes proposed in the 1987 White Paper were consistent with the approach set out in the 1985 discussion paper and the initial measures introduced in the February 1986 budget. These changes in the corporate income tax include:

1. A gradual reduction in federal statutory corporate tax rates starting July 1, 1988. The general rate will be reduced from 36 to 28 per cent. The tax rate on manufacturing income will drop four percentage points to 26 per cent and decrease further by 1 percentage point per year to reach 23 per cent in 1991. The small business rate is reduced from the current 15 per cent to 12 per cent. The special rate for small manufacturers is eliminated and the small business rate of 12 per cent will apply.
2. Capital cost allowance rates on various classes of depreciable assets are to be substantially reduced contributing approximately 27 per cent of the total corporate base broadening of 20 per cent.
3. The proportion of capital gains to be included in the income of corporations will be increased from one-half to two-thirds in 1988 to three-quarters in 1990.

4. Basic investment tax credits (ITCs) will continue to be phased out up to 1989 as announced in the 1986 budget. Special ITCs for high cost exploration and R&D remain while regional tax credits are retained but at lower rates that are in line with reduced CIT rates.

5. The mining sector maintains access to flow-through share financing, accelerated CCA, immediate deduction for all pre-production expenses, and other incentives with the exception of earned depletion which will be phased out.

6. Significant changes are to be made to the tax treatment of financial institutions such as banks and insurance companies, including an investment tax on the build-up of investment income relating to tax-exempt policies; a reduction in deductions for certain reserves and a comparable tax treatment of reserves for all types of financial institutions. The measures applicable to finance and insurance industries will contribute 28 per cent of the total corporate tax base broadening over the next five years and will increase the percentage of financial statement income of profitable firms in this sector which is subject to tax, from 49 to 74 per cent.

7. The introduction of a general anti-avoidance rule and compliance measures to better identify and audit tax avoidance arrangements and identify tax evasion situations. A new tax is introduced on preferred share dividends which will affect non-taxable companies. These measures are expected to contribute to over 18 per cent of total CIT base broadening.

In implementing these changes, the federal government will increase the share of total tax revenue it collects from corporations from 15.6 per cent to 17.2 per cent by 1992. Corporate tax revenues will have increased by over $5 billion over that period. The percentage of financial statement income for profitable firms that are subject to tax will increase from 72 to 84 per cent.

Table 11.3 shows the impact of CIT base broadening by sector. All sectors are affected. However, the sectors where income subject to tax is the lowest prior to tax reform are also those where the largest broadening of the tax base will occur. These sectors are finance, mining and manufacturing. The financial sector will bear the largest increase in average tax rates. Mining and manufacturing will experience much smaller increases while remaining sectors will see their average tax rate reduced. The government estimates that these reform measures may reduce, by almost one-half, the number of profitable corporations who do not pay tax (34 per cent in 1983). Table 11.3 also demonstrates that tax reform will considerably reduce the variation in average CIT rates among sectors. The average tax rate prior to tax reform varied from 14.5 per cent for the financial sector to a high of 24.5 per cent for the wholesale trade. Following tax reform, the agricultural sector will have the lowest average rate of 15.5 per cent while wholesale trade faces a reduced top rate of 22.6 per cent. The reduction in average tax rates for most sectors, and the reduced variation in rates among sectors are expected to provide an incentive for firms to invest on the basis of the underlying profitability of investments rather than on tax considerations. The corporate tax burden on the small business sector is unaltered by tax reform.

Table 11.3 shows that the net effect of the revenue-enhancing measures proposed for the CIT will be concentrated in three sectors. The financial sector will bear most of the burden of tax increases but mining and manufacturing will be affected as well. The remaining sectors will benefit overall from the reduced CIT statutory rates.

Table 11.3
Average Federal Tax Rates and Taxable Income as a Percentage of Financial Statement Income for Profitable Corporations

	Before tax reform		After tax reform	
	Average tax rate	Per cent of income taxed	Average tax rate	Per cent of income taxed
	(per cent of financial statement income)			
Agriculture, forestry and fishing	16.9	91.3	15.5	94.5
Mining	15.0	49.8	16.6	63.9
Oil and gas	21.4	67.9	20.3	75.4
Manufacturing	18.9	77.1	19.7	89.1
Construction	20.1	96.1	18.8	102.4[1]
Wholesale trade	24.5	94.7	22.6	101.0[1]
Retail trade	21.2	98.9	19.5	103.8[1]
Financial institutions, insurance and real estate	14.5	48.7	21.3	74.0
Services	20.4	94.1	18.9	98.8
Total, all industries	18.7	72.4	19.6	84.1

1 taxable income in some sectors can exceed financial statement income in a year if depreciation claimed on financial statements is greater than capital cost allowance claimed for tax purposes. This can occur where depreciation claimed for tax purposes has exceeded that deducted on financial statements in previous years as a result of accelerated write-offs.

Source: Department of Finance, *Tax Reform 1987: Income Tax Reform*, p. 43.

The effects of CIT reform are also likely to be concentrated in a few specific provinces. In 1984, close to 87 per cent of the total taxable income of the Canadian financial sector was allocated to four provinces, with Ontario's share being as much as 44 per cent. In the same year, 82 per cent of the total taxable income of the Canadian mining sector accrued to Alberta. Manufacturing taxable income is also very concentrated with nearly 81 per cent accruing to Ontario and Quebec (56 per cent and 25 per cent respectively). Ontario, Quebec, and Alberta are therefore likely to bear most of the legal burden of higher federal corporate income taxes. However, these three provinces collect their own CIT, and so they will probably have to decide whether to follow suit and adopt similar base broadening measures – which would lead to greater reliance on the CIT as a provincial revenue source – or whether to maintain current measures and possibly adopt further provisions to counteract the federal reform. This decision will probably depend upon the new provincial revenue requirements generated by the implementation of the federal tax reform package; in particular, the reduced reliance on PIT and the provincial implications of a new federal sales tax. However, as Grady[2] (forthcoming) indicates, Quebec and Ontario have already implemented measures to counteract federal efforts to reduce tax incentives in the manufacturing sector.

5. Impacts on Provincial Revenues

The federal government has provided its estimates of the direct impact of personal and corporate income tax on provincial government revenues (see Table 11.4). However, these numbers are not very useful for two main reasons. First, the estimates include an adjustment for the effect of tax reform on federal-provincial transfer programs (Established Programs Financing and Equalization). Second, the numbers are based on certain crucial and not necessarily realistic assumptions as to the likely response of provincial governments outside the tax collection agreements. In the case of the corporate income tax it is assumed that Ontario, Quebec, and Alberta will adopt the similar base broadening measures while retaining the same tax rates. It is also assumed that Quebec would make personal income tax reductions equivalent to about 80 per cent of the reduction in federal basic tax. The large positive numbers reported in the table for Ontario and Alberta are likely the result of these assumptions. The large negative estimates for Quebec reflect the drop in reliance on PIT which is not entirely compensated for by the higher CIT collections and the increased transfer receipts. Finally, the positive estimates in the first year occur as a result of the adjustment measure proposed by the federal government to accelerate PIT payments to the provinces within the tax collection agreement for 1988.

Table 11.4
The Direct Impact of Personal and Corporate Income Tax Reform on Provincial Government Revenues, Taxation Years 1988-1992

Province	1988	1989	1990	1991	1992
			(millions of dollars)		
Newfoundland	-1	-8	-2	-	+2
Prince Edward Island	-	-2	+1	-	-
Nova Scotia	+1	-10	-1	+3	+5
New Brunswick	-	-10	-2	+2	+4
Ontario	+77	-18	+112	+180	+227
Manitoba	+7	-7	+5	+10	+14
Saskatchewan	+4	-7	+2	+10	+11
Alberta	+36	+8	+51	+68	+83
British Columbia	+1	-35	-6	+7	+18
Northwest Territories	+1	-1	-	-1	-
Yukon	-1	-	-	-1	-
Total Excluding Quebec	+125	-90	+160	+278	+364
Quebec[1]	-186	-188	-165	-167	-155
Total	-61	-278	-5	+111	+209

1 Quebec's personal income tax system differs substantially from that of the federal and other provincial governments. Because the Quebec personal income tax system is not linked to the federal system, personal income tax reform will not directly affect Quebec personal income tax revenues. However, it is assumed for purposes of this table that Quebec makes personal income tax reductions equivalent to about 80 per cent of the reduction in federal basic tax.

Source: Department of Finance, *Tax Reform 1987: Income Tax Reform*, p. 50.

6. Sales Tax Reform

The problems with the current manufacturers' sales tax have been recognized for over thirty years. Virtually every assessment of the MST has brought forward the same criticisms. The recommendations for reform have varied from those that favour shifting the tax to the wholesale or retail level, to those that suggest the tax be replaced by a value-added tax, or to those that suggest the MST be eliminated altogether. Following a lengthy debate on this question, a 1983 federal sales tax review committee eventually recommended that the MST be modified on an interim basis in order to alleviate some of its most blatant discrepancies, at least until a longer-term solution (such as a value-added tax) could be worked out. The February 1986 budget indicated that the government was looking at the possibility of replacing the MST with a business transfer tax (a multi-stage sales tax). In the meantime, the government decided to undertake a comprehensive tax reform effort and as the 1987 White Paper indicated, the implementation of a multi-stage sales tax was then seen as a cornerstone of the tax reform package.

> Major reform of the federal sales tax system is an integral part of the government's plan for comprehensive tax reform. Together with reform of the personal and corporate income tax systems, sales tax reform is an opportunity to strengthen economic growth in Canada and to improve tax fairness. It is an opportunity to build a tax system that is well suited to the demands of a competitive international marketplace: first, because it will strengthen the ability of our industries to compete in foreign and domestic markets; and second, because a fair and effective sales tax system will provide the necessary balance among revenue sources that is essential to a competitive personal and corporate tax structure with lower marginal rates.[3]

Sales tax reform has been cited under most of the key objectives of policy reform; that is, fairness, balance across revenue sources, stability of revenues, economic growth incentives, international competitiveness, simplicity, administrative efficiency, and tax compliance. There is widespread support within the tax profession for federal reform of indirect taxation insofar as it offers to eliminate the MST. No tax currently in force has been so soundly criticized for such substantial and varied reasons as has the MST. For example, the MST arbitrarily excludes personal services while it just as arbitrarily includes some producer goods such as computers, office machinery, passenger cars, and fuels. It is possible that up to 50 per cent of MST collections originate from business purchases of capital goods and intermediate products, with implications for both the scale and factor mix of industrial production. The MST introduces an effective rate of tax on production that is randomly determined by capital-intensity, distribution patterns, the degree of vertical integration, and even advertising to the extent that such costs are incurred prior to sale by manufacturers. The MST distorts trade by making it difficult to determine the correct border tax adjustment on Canadian exports of manufactured goods. The problem goes beyond manufactured exports to any export produced or processed by capital or other inputs that have borne the MST. Furthermore, since no single composite rate exists for a given product, no definable rate of compensatory import tax can be assigned to imports so as to impart exactly the same tax burden as that borne by comparable domestic products.

As was mentioned at the beginning of this chapter, sales tax reform was to be undertaken in a second stage following consultation with provincial governments and businesses. In particular, the government indicated its intention to "explore the opportunity of a national system fully with the provinces before implementing sales tax reform."[4] In the interim, changes were to be brought to the MST in an effort to prevent revenue leakages and to broaden

the tax base. These included a shift to the wholesale level for a range of products; the application of the tax to sales by marketing companies related to manufacturers and to telecommunications services such as telephone and telex services. The additional revenue (approximately $1 billion per year) was to be used to finance the stage one reduction in personal tax rates. Furthermore, the value of the refundable sales tax credit was to be increased somewhat. In addition to the introduction of a new sales tax, second stage measures were also to include the removal of existing PIT and CIT surtaxes, further PIT reductions for middle-income taxpayers, and an enhanced refundable tax credit. Even with the 1989 budget, the final format of the new sales tax had not been decided. Nevertheless, the government has formally announced its proposal to replace the current MST with a broad-based multi-stage sales tax that extends to the retail level. The tax will be a form of value-added tax that will be levied on, and collected from, businesses in stages as goods move along the production and distribution stream. Businesses will charge tax on sales and receive a credit for tax paid on their purchases. In essence, the system levies a tax on the value-added by each business. Imports are taxable at the time of importation and export sales are to be excluded from the tax base.

The multi-stage sales tax is superior to a manufacturers' or a wholesale sales tax with respect to all three principles of indirect taxation: consumption neutrality, production neutrality, and locational neutrality. Such a tax is meant to be applied on a broad range of goods and services and levied on the value-added at each stage of production. As a result, the tax is a uniform percentage of the final price of goods and services to consumers; it does not influence the production or distribution process; it completely removes the tax on business inputs and eliminates tax cascading; and it ensures that exports carry no tax burden. Because the multi-stage sales tax applies to the value of imports at the time of importation as well as at subsequent processing and distribution stages, if they occur, the tax eliminates the import bias implicit in the current MST system.

In theory, the value-added tax is equivalent to a retail level consumption tax. However, it offers a number of advantages over the retail sales tax as currently applied in most provinces. These advantages are that:

(a) it eliminates tax on purchases of capital goods, intermediate products and other inputs;

(b) it facilitates accurate border tax adjustments;

(c) it has the advantage of being collected throughout the production-distribution process rather than entirely at the retail level; and

(d) it has enormous revenue potential.

The main disadvantages of a value-added tax are the large administrative and compliance costs required to implement it. A further disadvantage, one that is common to all general indirect taxes, is the regressive incidence of a VAT. Indirect taxes are perceived as imposing a relatively heavier burden on low-income taxpayers who consume a greater proportion of their income than those who are better off. This argument is usually used to justify sales tax exemptions on certain goods considered necessities such as food, clothing, and prescription drugs. However, the position taken by the government in its White Paper is that (a) such tax exemptions generally provide a greater absolute benefit to higher-income people than to those at lower-income levels; (b) that exemptions lead to higher tax rates on

everything else; and (c) that a refundable sales tax credit is a better way to offset the effects of the total tax paid by lower-income families. The government's preference is therefore for the taxation of a broad range of goods and services at a lower rate and the use of a refundable sales tax credit against the PIT to improve overall equity. As public debate over exemptions developed, the government announced its intention to provide several significant exemptions.

The White Paper described three alternative methods that were considered to implement a multi-stage sales tax: (a) a national sales tax that could replace both the current federal sales tax and the existing provincial retail sales tax; (b) a federal value-added tax; and (c) a federal goods and services tax. Decisions on the tax rate, the base definition and the value of the sales tax credit would all depend on which of these options was to be implemented. By 1989, the federal government's use of the term "goods and services tax" no longer corresponded with the following definitions from the 1987 White Paper.

(a) National Sales Tax

A combined federal-provincial value-added tax was the preferred alternative proposed by the federal government. A uniform tax base would apply on a national basis but in addition to the federal rate of tax, each participating province would set a provincial rate that could vary among provinces. The tax would be legislated separately by the two levels of government. For businesses who do not engage in interprovincial trade, the calculation of the tax would be based on one rate. For others, the rate of tax would be determined by the destination of the goods. The national sales tax would be calculated separately on sales invoices to enable businesses to separate their sales to, and purchases from, provinces with different tax rates. The attraction of this proposal was the opportunity it offered to minimize the overall compliance and administrative costs by eliminating the duplication that two separate sales tax systems entail. The government also underlined the fact that the economic benefits of reform would be maximized by fully removing the burden of sales taxes on business inputs at both levels of government. A further advantage of the credit and invoice method is that it is largely self-enforcing. Both parties to each transaction (except for consumer sales) use the same tax information on the sales invoice, and the purchaser in particular has an interest in ensuring that the tax is paid by the supplier and is clearly indicated.

(b) Federal Value-Added Tax

This tax would be similar to the VAT currently used in Europe. The tax is also computed on an invoice-by-invoice basis and therefore would enable the exemption of selected goods and services or selected classes of business operators. This property can be seen as either an advantage or a disadvantage. On the one hand, it provides a flexibility that may be useful for a government wanting to use the tax system to achieve certain policy objectives. On the other hand, the fact that exemptions are feasible means that the government will automatically be under pressure to allow exemptions and this is usually a cumulative process. This form of taxation then becomes subject to base erosion in much the same way as the existing manufacturers' and retail sales taxes are. It also means that higher tax rates will be required on the items that remain taxable. A real disadvantage of this method is the additional paper burden and compliance costs involved, particularly for retailers who would have to comply with two

separate tax systems (a federal VAT and a provincial RST). The provision of VAT exemptions would also exacerbate this problem.

(c) *Federal Goods and Services Tax*

This tax would be applied at a uniform rate to virtually all goods and services in Canada and therefore, would not require a separate tax calculation on each invoice. Instead, tax liability could be calculated using information from the businesses' books of account already maintained by multiplying taxable receipts by the tax included rate of tax and deducting the tax paid on purchases calculated by multiplying taxed purchases by the rate. This method does not provide the same flexibility as the VAT in terms of possible exemptions or rates. When these are introduced it becomes necessary to keep track of the purchases involved which is only practical under a system with tax invoicing. This lack of flexibility may be seen as an unacceptable feature. On the other hand, this method, because of the constraints it imposes, results in a less distortionary tax. Although the federal government refers to its 1989-1990 version as a "goods and services tax," the 1989-1990 version does not comply with this 1987 definition, since it provides for exemptions and it requires tax calculations on each invoice.

The implementation of a federal sales tax probably raises the most important issue that provinces will have to face regarding federal tax reform. The government has proposed a combined provincial-federal value-added tax – the national sales tax – as its preferred option, although it is prepared to proceed with a federal multi-stage sales tax if an agreement with the provinces cannot be reached. For the provinces, the decision whether to opt for a joint sales tax could be a difficult one. The issues are more likely to be related to political concerns rather than economic factors. From the provincial perspective, the advantages of a national sales tax are numerous. Basically, the multi-stage sales tax is a better indirect tax than the retail sales tax as currently implemented. A multi-stage sales tax, because of the way it is levied, virtually eliminates the taxation of capital goods, intermediate goods, other business inputs, and the tax cascading that results from such a practice. It also facilitates accurate border tax adjustments. Federal government documents suggests that perhaps as much as one-third of provincial sales tax revenues are accounted for by taxes on business inputs.[5] Although some provinces have introduced measures to improve this situation, indications are that the problem remains.

Compared with a retail sales tax that is collected entirely at the retail level, the VAT is advantageous because it is collected throughout the production-distribution stream. Finally, because the VAT will likely apply on a much broader base covering most goods and services, the tax has enormous revenue potential – revenue that can be collected in a relatively non-distortionary framework. In the past few years, some provinces have attempted to bring some services into the retail sales tax base. However, these base-broadening measures have had only modest results, and efforts to enhance revenues have usually resulted in higher rates that further exacerbate the distortionary effects of the tax and generate additional pressures on governments to provide tax exemptions. This has been a problem particularly in the Atlantic provinces and Quebec where RST rates are close to double those of the Western provinces.

In opting for a national sales tax, the provinces would adopt a more comprehensive and less distortionary sales tax that would simplify compliance for taxpayers and eliminate the duplication of tax administration. The use of a common national tax base would constitute a

constraint on the provision of tax exemptions which would discourage tax base erosion and related rate increases. The neutrality of the tax could thus be better maintained. Having the ability to set separate provincial tax rates, individual provinces could choose to follow the lead of the federal government and increase their reliance on the sales tax as a source of revenue. As with the federal portion of the tax, equity concerns would be addressed through the use of refundable PIT credits. This approach is widely recognized as being more efficient.

The main drawback of the national sales tax option is that provinces would have to enter additional tax agreements with the federal government (in effect, with other participating provinces) to define a common tax base. Given that most provinces already have a tax-sharing agreement with the federal government concerning the personal and corporate income taxes, and given that the retail sales tax is, in most provinces, the only major tax revenue source under total provincial control, such a move could be perceived to entail the loss of remaining provincial tax autonomy. This could severely reduce the provincial scope for policy intervention through the tax system. For instance, the provinces may consider that their retail sales tax system incorporates a history of decisions to achieve certain provincial social, economic, and political objectives and that therefore, the national sales tax option is too costly for them. This subject is considered further in Chapter XII.

Another issue with a VAT is more one of perception. The current federal MST is, in effect, a hidden tax that most consumers are not aware of while the retail sales tax, because it is quoted separately on purchases, is quite visible. A new national sales tax might also be quoted separately with the applicable rate being the combined federal and provincial rate. This rate would likely be significantly higher than current RST rates and could be seen as unjustifiably high by taxpayers.

A NST would be levied on the value added at each stage of the production and distribution stream. However, over 75 per cent of value added in Canada originates in three provinces – Ontario, Quebec, and Alberta – with Ontario accounting for about 40 per cent. The remaining provinces account for only a minor share of total value added. This would be reflected in the tax bases of these provinces. On the other hand, it should be kept in mind that (a) the NST would apply on a broader range of goods and services than the current RST; (b) the NST applies on a destination basis which means the tax collected on the value added just prior to the retail stage, be it manufacturing or wholesale, would accrue to the province where the goods are shipped; and (c) that provinces with a smaller share of value added also have smaller revenue requirements.

The issues at stake in the federal-provincial negotiations are many and varied. The following chapter develops a possible agenda for these negotiations, indicating the implications of alternative choices. A central perspective in this analysis is that an agreement cannot be reached easily or quickly. The federal government's 1989 budget indicated the decision at that time to proceed, independently of the provinces, with a new goods and services tax. Nevertheless, it is likely that the advantages of unified action that have been discussed above will lead to future negotiations, and the issues presented in Chapter XII will retain their significance.

7. Evaluating the Federal Reforms

Although the tax reform process was already in motion in Canada prior to the latest tax reform events in the United States, the momentum gained in the United States, along with various other domestic political factors, have succeeded in bringing comprehensive Canadian tax reform to the agenda of the federal government. The major themes north and south of the border are the concerns over efficiency, growth, and the desire to reduce the influence of the tax system on market operations. The basic approach consists of broadening the tax base and lowering rates.

There are however, some important differences between the measures implemented in the 1986 U.S. Tax Reform Act and the initiatives of the Canadian government. The main difference relates to the tax mix. Both countries plan to reduce their reliance on the PIT as a revenue source. Whereas the United States intends to compensate for the revenue loss by increasing CIT collections, the Canadian decision is that both CIT and federal sales tax increases are to be expected. Indeed, the implementation of a new multi-stage sales tax to replace the existing manufacturers' sales tax is seen as the cornerstone of Canadian tax reform. On the other hand, reform in the United States has been limited to direct taxation. Other important differences can also be pointed out at both the PIT and CIT levels. For instance, the White Paper proposals suggested that no attempt would be made to match the 20 per cent alternative minimum tax on U.S. corporations. On the other hand, the conversion of personal exemptions and many deductions to credits indicates a new distinctive approach to income redistribution in Canada.

Base-broadening measures in the United States have enabled significant reductions in both PIT and CIT statutory rates. Rates will also be reduced in Canada, however these reductions will not bring rates down to levels approaching those in the United States. For instance, by 1988 the typical maximum personal tax rate (federal and state combined) in the United States was about 35 per cent, and the corporate income tax rate was about 38 per cent.[6] In Canada, the drop in the top federal marginal PIT rate from 34 to 29 per cent and the drop in the general business federal rate from 35 to 28 per cent brought the top combined marginal PIT rate down to around 50 per cent and the combined marginal CIT rate down to about 42 per cent (assuming there is no change in provincial rates). Although the new CIT rates are comparable between the two countries, a significant gap remains in the PIT rates and this may be cause for some concern. However, there are a number of considerations that should be kept in mind. First, there is the fact that the Canadian tax system prior to tax reform was not riddled with special tax provisions to the same extent as was the system in the United States. Therefore, base broadening here, even though extensive, did not enable the same level of rate reductions. Second, the high level of government services in Canada will not permit such a dramatic reduction of rates. Third, Canada has chosen to maintain a more favourable tax treatment of retirement savings and capital gains. Fourth, it should be kept in mind that residents of the United States pay significantly higher social security taxes than do Canadians. Finally, manufacturers in Canada will continue to enjoy a lower statutory CIT rate than other businesses.

It is too early to evaluate the net economic impact the Canadian reforms will have. The reform package contains measures that improve both the equity and efficiency of the tax system. On the other hand, as the first round of assessment suggests, the counteracting effects underlying this reform are such that it is difficult to judge whether tax reform will result in a substantial improvement overall.[7] For example, the increased taxation of capital income

under the PIT improves the neutrality of the tax but also exacerbates the preferential treatment provided to current consumption over saving and future consumption. Moreover, the answer to this question will greatly depend on the response of the provincial governments to the federal initiative. As Brown (1987) emphasizes, the provinces and local governments of Canada currently raise close to one-half of total tax revenues and account for over one-half of total government expenditures.[8] Provinces play a greater and more independent role in Canada than do the states in the United States, and for that matter, other local governments in most other countries. Also, the differences in political philosophy and economic circumstances among the provinces mean that policy priorities and requirements can be expected to vary quite dramatically.

Provinces will be affected by federal tax reform in two ways. First, the reform proposals will affect all taxpayers differently depending on whether they are wage earners, investors, consumers, savers, self-employed, or a combination of these. Whether residents of a province end up paying more or less federal taxes will depend on the location and the relative importance of these various activities. Moreover, the net impact of the tax changes may be felt by individuals other than the ones from whom the tax is collected. This is because in some instances, the tax burden can be shifted through changes in factor prices or consumer prices. The multi-stage sales tax is a good example of that. The tax will be collected on the value-added at all stages of the production and distribution process, however, most of the burden of the tax will be shifted forward to consumers in the form of higher prices. This shifting determines the true incidence of the tax. As a result of tax reform, some provincial residents will have more income while others will have less income at their disposal. Certain sectors which previously enjoyed preferential tax treatment under the CIT will face a heavier tax burden as a result of base broadening, while others will benefit from the rate reductions. This will also affect activities in certain provinces.

The assessment by Melvin (1987) of the regional impact of federal tax reform suggests that the changes will be fairly neutral. The author argues that sales tax reform will generate considerable real income gains for the economy and that these gains will be as substantial for the smaller regions as for the larger regions where manufacturing is concentrated. Also, because consumption patterns do not differ significantly across regions, there should be no major shift of the tax burden as a result of the introduction of the new sales tax. Melvin also does not expect any major regional consequences as a result of CIT reform. He notes that in spite of lower rates, the difference among rates applicable to the three types of industries (general business, small business, and manufacturing) have been maintained. The financial sector emerges as the big loser as a consequence of base-broadening measures. Again, the net impact is expected to be neutral because the burden is expected to pass onto consumers. PIT changes should benefit the provinces that are less well off, but the effect will probably be small.[9]

The other effect of federal tax reform upon the provinces is the impact on government revenues. The reduced reliance on the PIT as a source of revenue will mean reduced PIT collections for all provinces except Quebec, if provincial rates are not adjusted. It appears that the Atlantic provinces may be affected the most by these reductions. CIT base broadening should result in higher revenues for the provinces as well as the federal government but, as indicated in this chapter, the impacts of revenue enhancing measures are likely to be concentrated in the three provinces that maintain a separate CIT system. These changes will also bring about transfer payment adjustments, as discussed in Chapter XII.

Sales tax reform will also have implications for provincial finances. The provinces could opt for the NST alternative and perhaps even choose to follow the lead of the federal government and increase their reliance on sales taxation as a source of revenue. Alternatively, they could maintain a retail sales tax system parallel to the new federal sales tax. In this case revenues could be affected since the RST applies to the retail value gross of the federal sales tax. Compared with the existing MST, the new federal sales tax is expected to apply at a lower rate and on a much broader range of goods and services. The tax cascading resulting from the taxation of producer and capital goods should also be eliminated. It is not clear what the net impact of these changes would be on provincial RST revenues.

Provinces have a variety of options in responding to the implementation of the federal tax reform proposed in the White Paper. The preference of the federal government has been that provinces cooperate in the reform effort, or at least not counteract the proposals, by opting for a national sales tax, and by not raising provincial PIT and CIT rates. In the case of provinces outside the tax collection agreements, it was suggested that Quebec could also reduce its reliance on the PIT and that the provinces who operate their own corporate tax regime could parallel federal base-broadening measures. Such an adjustment on the part of the provinces would have enhanced the proposed federal measures. However, it may leave most provinces with very little tax autonomy, reduced tax revenue, and a greater dependence on federal transfer payments. This may prove to be an unacceptable proposition.

The provinces could react by increasing provincial PIT and CIT rates. Alternatively, they could decide to break away from the tax collection agreements and pursue their own tax policies, particularly if it were felt that certain reform measures will unduly affect particular residents or activities, to the detriment of the local economy. Such an approach would be simple for provinces already outside of the tax collection agreements. Quebec and Ontario have already demonstrated this by implementing measures to restore the preferential position of their manufacturing sectors.[10] The risks involved are twofold: (a) the provincial reaction could counteract the effects of federal measures; and (b) the loss of uniformity in the total income tax system would create additional inter-provincial barriers to trade and investment. Both situations could result in welfare loss. Since provinces have already begun to look to alternative tax sources for additional revenue and policy implementation (see recent Ontario and New Brunswick budgets), there is also some concern that an increased reliance on payroll taxes, corporate taxes, and retail sales taxes on business inputs and costs may make the economy less competitive and the overall tax system more distortionary.[11] In any event, it would appear that there is much to be gained from federal-provincial consultation and cooperation on this matter.

The federal tax reform package includes several efficiency-improving measures that would be beneficial to the operation of the economy. These include PIT and CIT rate reductions. These are significant because higher rates exacerbate the distortionary effects of these taxes such as the disincentive effects on work and investment. Also, the base-broadening measures within the PIT and the CIT structures reduce the variation in effective tax rates on different sources of income, different industries, and different assets. Perhaps the major efficiency improving measure would be the replacement of the highly distortionary MST with a more neutral, broadly based, multi-stage sales tax imposed at a lower rate. The major criticism of the White Paper is likely to be its failure to deal with inflation. The new system provides no means of adjusting investment income, capital cost allowances, inventory valuation, and interest deductions for inflation. It can also be argued that in making the

taxation of capital income more neutral, tax reform increases the intertemporal distortion of the PIT. The tax is seen as favouring current consumption over savings and hence, future consumption. These elements are often cited as the main problems associated with direct taxation on an income base. The case for a consumption tax is usually based on these concerns. The difficulties associated with the full integration of corporate and personal taxes are also an issue.

In terms of equity it is the overall impact of tax reform on incidence that is of interest. Some of the reform measures will reduce the progressivity of the tax system, such as the PIT rate reductions and the greater reliance on the sales tax. However, other measures such as the conversion of exemptions and deductions to credits, the enhanced sales tax credit, the increased taxation of capital income, and the greater reliance on CIT as a revenue source, will enhance the progressivity of the tax system. The eventual structure and size of the refundable sales tax credits would be an important determinant of the progressivity of the tax system.

From the provincial point of view, the large increases in effective tax rates on new investment, following the elimination of general investment tax credits and the reduction of capital consumption allowance rates, may be seen as a particularly costly element of improved tax neutrality given the potentially negative effect of these measures on capital formation and investment. The maintenance of lower statutory rates on small business, regional and R&D investment tax credits, and retirement savings deductions are likely to be viewed more favourably. Because of the substantial differences among provincial economies as discussed in Chapter V, the impact on provincial residents' federal tax payments and the impact on provincial revenues will vary considerably among the provinces.

Notes

1. Allan M. Maslove, *Distributional Impacts of Personal Income Tax Reform*, Discussion Paper – Studies in Social Policy Program (Halifax: Institute for Research on Public Policy, 1988), p. 9.
2. Patrick Grady, "Real Effective Corporate Tax Rates in Canada and the United States After Tax Reform," *Canadian Tax Journal* forthcoming.
3. Michael H. Wilson, *Tax Reform 1987: Sales Tax Reform* (Department of Finance, 1987), p. 1.
4. *Ibid.*, p. 2.
5. *Ibid.*, p. 27.
6. See Robert D. Brown, "Canadian Tax Reform: Can We Do Better the Second Time Around?", in *Proceedings of the 38th Tax Conference* (Toronto: Canadian Tax Foundation, 1987), pp. 3.1-3.31.
7. See for example, J. Whalley and J. Mintz, eds., *The Economic Impact of Tax Reform* (Toronto: Canadian Tax Foundation, 1989).
8. See Brown.
9. J. Melvin, "The Regional Impact of Federal Tax Reform," in *The Economic Impact of Tax Reform*, eds. J. Whalley and J. Mintz (Toronto: Canadian Tax Foundation, 1989).

10. Patrick Grady, "Real Effective Corporate Tax Rates in Canada and The United States After Tax Reform," *Canadian Tax Journal* forthcoming.

11. See for example, Brown, pp. 3.1-3.31.

Chapter XII

The Proposed Goods and Services Tax (GST): An Agenda for Federal-Provincial Negotiations

1. Introduction

The federal government's August, 1989, *Goods and Services Tax (GST) Technical Paper* forms a focus for debate about many possible features of Canada's proposed value-added tax. However, the Technical Paper is not written from the perspective of federal-provincial relations, and issues are not presented concerning possible integration of provincial retail sales taxes with the GST. Particularly for the compliance costs of small businesses, federal-provincial integration is of paramount importance. Without integration, businesses will have to make separate tax calculations and bookkeeping entries for many sales, because the tax systems will have different tax bases, offering different sets of exemptions. For large businesses, sophisticated computers can facilitate this process, but for small businesses the compliance costs and confusion caused by two separate tax systems will be very great.[1]

The thrust of this chapter is that a large number of serious issues remain to be resolved prior to any federal-provincial agreement to integrate the proposed GST with the existing provincial retail sales taxes. The negotiation process will be complex and lengthy. Disagreements will be many, and will arise not solely from political gamesmanship, but rather because the negotiation agenda involves issues that are central to the federal-provincial distribution of money and power. Provincial leaders are concerned about many of the design features proposed in the Technical Paper. This chapter seeks to clarify the options about which the provinces will likely express concern. Many of these issues will not disappear with the introduction of the GST. The advisability of integrating federal and provincial sales taxes will persist as an important subject even if the federal government proceeds on its own. In this respect, the federal-provincial history of negotiations over the personal and corporate income taxes, and the many changes in agreements over integrating these taxes between the federal and provincial levels, suggest the probable importance of the GST in future fiscal relations.

The federal government has emphasized that the existing federal sales tax is far from optimal and that a new GST based on a *value-added* concept would reduce economic distortions and would foster Canadian international competitiveness.[2] If provincial retail sales taxes were integrated with a new GST of this type, existing distortions caused by the taxation of business inputs at the retail sales tax level would also be removed.[3] Nevertheless, a federal-provincial agreement would have to include decisions in regard to revenue sharing among the provinces, the distribution of tax burden among corporations and individuals, administration and compliance procedures, and alternative structures for future tax modifications. If some provinces do join the GST while others refuse to join, then negotiations must consider alternative ways of operating the integrated GST in parallel with the remaining provincial sales taxes, and perhaps alternative ways of combining certain features. Furthermore, the integration of provincial retail sales taxes in a new GST would also require that each province reach its own decisions on a series of other issues such as the provincial rate to be added onto the federal rate, provincial income tax rebates for those with low incomes, the forecasting of provincial revenues, and the sharing of provincial tax burdens among corporations and individuals.

2. Revenue Aspects

Equalization Payments and Established Programs Financing

A federal-provincial agreement would likely involve a restructuring of many federal-provincial fiscal arrangements, including equalization payments and established programs financing. If any provinces surrender their existing retail sales taxes to become part of the new GST, then the resulting alteration in tax rates could affect equalization payments to "have-not" provinces even if they are innocent bystanders in this process.[4] It is true that the provincial component of an integrated GST might be equalized in the same way and with approximately the same financial implications as the provincial retail sales taxes are equalized today. Yet the results might be different because there would be a new tax base, and a different set of exemptions. Consequently, provinces may seek a federal commitment that their equalization payments will not be reduced as a result of the GST. Yet such a request by each recipient province could result in an overall increase in equalization payments by the federal government.

With the new GST, there will be not only a change in the sales tax bases and rates which may affect equalization payments, but there will also likely be changes in many other provincial tax structures, and the degree to which the provinces rely on alternative taxes. These changes mean that it is not possible to estimate the impact of the GST on equalization payments until provinces have made adjustments in their reliance on other taxes as a result of the introduction of the GST. For recipient provinces, it is because of this uncertainty that a federal commitment may be necessary.

Imposition of the GST will add a significant new element to federal-provincial fiscal relations, and so it may lead to the reconsideration of other elements of these relations. Under the established programs financing (EPF), the federal government provides the provinces with certain amounts of funding for specific programs. Some people may wish to re-examine the dollar amounts of EPF in the light of changes accompanying the GST. The health care, education, and welfare programs have experienced frequent substantial changes over the past

twenty years. With the GST, the change in tax sharing and tax mix might be a significant departure from the fiscal structure that was in place when EPF was last negotiated. It is likely that the GST will alter the current federal-provincial fiscal arrangements to such a degree that all these federal funding programs will have to be reconsidered. In any such reconsideration and negotiation, it is likely that each province's interests will be presented forcefully. Again, the provinces may request a federal commitment that EPF will not be reduced as a result of the GST. The important point here is that GST can not be designed in isolation from the other elements of federal-provincial fiscal relations. Furthermore, these relations will be impacted by political decisions concerning the reduction of budget deficits.

Allocation of Provincial Shares of An Integrated GST

If the GST takes the form of a single integrated federal-provincial tax, then a major subject will be the allocation to each province of a share of the aggregate revenue. This allocation could be made on the basis of a variety of different procedures. A central question concerns the appropriate division of the revenue from a consumption tax among the various provincial jurisdictions where production and consumption of the good or service occurs. One theoretical perspective is to consider the relationship between GST revenue and the government expenditures connected with the production and consumption of the particular good or service that has been taxed. Which governmental jurisdiction incurs expenditures as a result of the production and consumption? One might argue for a revenue allocation based on the answer to that question. In practice, however, some allocation rule or clearinghouse procedure has to be established, and there are various arguments that might support alternative rules and procedures.

Each province could be promised a certain portion of the GST based upon some formula. In Germany, for example, the states receive a portion of the GST based upon each state's population as a percentage of the total national population.[5] This approach, of course, involves implicitly a degree of equalization among states. It is interesting to note that the allocation formula has been a major issue of dispute in Germany. It is also possible that a Canadian formula could focus on each province's net provincial product as a percentage of the Canadian net national product. For a variety of reasons, some would argue that these solutions would be inappropriate.

Alternatively, each province could receive a certain portion of the GST that is collected from the firms operating in that province. An illustration of this concept can be found in the current federal-provincial agreements for allocation of corporate income tax between provinces. For corporations that conduct business in more than one province, a certain formula and ratios are used to distribute the corporate income tax among the provinces concerned. It is important to note that, with such a GST allocation, it is quite likely that some provinces would receive a particularly low percentage of the national revenue while others would receive a particularly high percentage. This is because the ratio of value added by corporations to total sales by corporations varies significantly among provinces. Consequently, with an allocation rule based upon value added in each province, the allocation of GST among provinces would not be the same as a similar allocation of retail sales tax revenue.

On the other hand, aggregate revenues could be divided on the basis of the *destination principle*. Each province could receive the full provincial share of all the tax at each value

added stage for all products and services where the final sales occur within its borders. The destination principle could also result in some provinces receiving a particularly low percentage of the national revenue while others would receive a particularly large percentage. Provinces that are net importers of goods and services from other provinces may gain from this procedure. Yet this destination principle would likely yield a revenue allocation relatively similar to that resulting from a uniform provincial retail sales tax.

If the destination approach is taken, then a series of problems will have to be resolved concerning the mechanics of a GST clearinghouse to deal with inter-provincial flows of goods and services. The provinces will have to be satisfied that the allocation system is clear and fair, and this agreement must be reached in a situation where alternative allocation practices will benefit different provinces.

With the destination principle and a clearinghouse through which GST revenue is divided in accordance with consumers' residences, a difficulty will arise when consumers make their purchases in provinces other than their province of residence. In such cases, the province where the purchase is made may be the recipient of all GST connected with the product, while the province of residence may receive no GST in spite of the fact that the latter may have to incur expenditures related to the resident. This situation may become common if GST rates vary significantly among the provinces, so that consumers may gain by making their purchases in low-tax provinces. At the present time, differences in provincial retail sales taxes may lead to a similar difficulty in revenue allocation, particularly in connection with the purchases by tourists. However, each province has developed ways of checking for sizeable consumer purchases in other provinces. With provincial surrender of control over sales taxes and with provincial reliance on federal enforcement, it is likely that this aspect of revenue allocation will become more serious. At the present time, countries in the EEC are debating the same issues in regard to allocation of value-added tax revenue, and the above concerns have been expressed frequently in the European VAT literature.[6]

Sijbren Cnossen has discussed a number of design features in regard to inter-jurisdictional sales. He notes the view that sellers of taxable commodities would have to identify the province of destination in each invoice and would have to charge tax at the rate prevailing in that province. In this view, they might also have to report their input tax credits for each provincial government separately. Cnossen has presented a different view in which it is the purchaser who identifies the origin of the sale. With Cnossen's approach the seller does not have to establish the identity of the purchaser or the reliability of the information provided by the purchaser.

> After all, under the destination principle, the whole of the revenue collected on any one product, netted for the revenue attributable to the federal tax rate, would accrue to the province of consumption or use. With regard to inter-provincial sales, the net balances accruing to each province would reflect the tax difference between the provincial tax collected out-of-state on imports and the variable rated in-state collections on exports to other provinces.
>
> In contrast, in a 1983 article, I have suggested (a proposal adopted in 1985 by the EC-Commission) that the member states of the EC do away with border controls by switching border tax adjustments to books of account. Exporters to other member states would charge tax on their sales (rather than zero rate them) at the rate of their own jurisdiction, regardless of the destination of the product. In turn, importers in other jurisdictions would identify that tax as regards its origin and claim the out-of-state tax credit, stated on the invoice, for it. The tax administration

> of the importing state would collate all tax credits attached to imports from other states and present them for settlement to exporting states. Net balances would be payable by states that are net exporters. . . .
>
> Whether or not the purchaser is entitled to a tax credit or whether or not the destination he claims for the product is the correct one, are matters between him and his tax administration, not between him and the seller.[8]

3. Distribution of Tax Burden

Income Tax Credits

A central concern about the GST is whether it will take more tax from low-income people than the federal manufacturers sales tax has levied in the past. Provinces, particularly those with low incomes, may request a federal commitment that low-income people will not be adversely affected by this change in tax structure. In this regard, provinces may request that the federal government fully index its GST credits. Otherwise, the value of the GST credits may fall significantly as incomes and prices rise. With the Technical Paper, the federal government has proposed a new refundable GST Credit as well as a new tax rebate on houses sold for less than $400,000.00. The Technical Paper also notes that the income tax rates for middle-income tax payers will be reduced in 1991. The Technical Paper presents a series of tables indicating the combined impact of these initiatives at various income levels and it claims that:

> The package of initiatives has been designed to ensure that assistance is targeted to those who need it. Families with incomes less than $30,000 will be better off as a result of the combined impact of the new GST and the offsetting income and housing assistance initiatives. These measures include $3.6 billion for the new GST Credit, $0.7 billion for the reduction in the middle income tax rate and $0.9 billion for the housing rebate. The result is a fairer tax system.[9]

It is important to note, however, that many low-income people do not file income tax returns. Consequently, the GST credits may not be used by all those who deserve them. Some low-income people, then, may be made worse off by the GST in spite of the proposed credits.

Tax Base: Exemptions, Definitions, Interpretations

Countries with a value-added tax have found that considerable public pressure has focused on certain products that people feel should receive special treatment. Many *necessities* have been seen as deserving zero-rating. If a product is zero-rated, then no tax is paid on purchases of the product. Furthermore, suppliers of the product receive a rebate of the tax paid on their inputs. As a result, the business that is involved in making this product pays no tax on its value added, since such a business receives a full credit for all of the taxes paid on the inputs it uses. Instead of providing zero-rating, a government may exempt certain products. Some necessities have been seen as deserving exemptions. If a product is exempted, then no tax is paid on purchases of the product. However, suppliers of the product do not receive a rebate of the tax paid on their inputs. As a result, the business that is involved in making this product does pay a tax, and to some degree this tax will be built into the product price. It is important to note this difference between zero-rating and exemption. Clearly, the product that is zero-rated and the producers of such a product receive more favourable tax treatment than the

product that is exempted and the producers of such a product. An alternative way of providing concessions for necessities, is to impose a lower tax rate on these necessities than is generally applied to goods and services. With this approach, a government may impose two or more different tax rates, with specific goods and services being placed into different categories.

Some provincial leaders disagree with the *Technical Paper*'s list of zero-rated and tax-exempt goods and services. At the present time, provincial retail sales taxes vary in regard to exemptions. Many, for example, exclude children's clothing. The *Technical Paper* proposes that the following be zero-rated: exports, basic groceries, prescription drugs, and medical devices. It is proposed that many supplies would be tax-exempt. It is also proposed that some domestic financial services will be tax-exempt, not solely because of tax burden considerations but also because of extremely high compliance costs likely to be incurred if these services were included. Apart from these exemptions for certain supplies, some organizations, such as provincial and municipal governments, educational institutions, and charities, will be given a rebate – or partial rebate – of the GST on their purchases.

While these categories for zero-rating and exemptions may be desirable, nevertheless, enormous difficulties will likely arise in agreeing on definitions and interpretations. With retail sales taxes, the provinces have had to develop voluminous regulations regarding particular items. European countries have also experienced continual problems of definition and interpretation.[10]

4. Tax Design

The self-supply bias

As indicated above, the *Technical Paper* provides for a series of exemptions and rebates. However, this approach can lead to a serious problem for suppliers of tax-exempt organizations if these organizations get a rebate less than the complete GST on their purchases. In the case of a rebate less than the complete GST, there will be a strong incentive for such institutions to supply these services internally, rather than buying them from outside corporations. The *Technical Paper* refers to this problem explicitly at several points. One proposed solution is that "registered charities, and those non-profit organizations which are substantially funded by governments, will be eligible for a rebate of 50 per cent of the GST paid on their purchases."[11] A very important practical question is whether a significant self-supply bias will still remain if only a 50 per cent rebate is allowed. With a GST of 9 per cent, an exempt organization could save 4.5 per cent of its costs by producing a good or service within the organization rather than purchasing it from a corporation. If provincial retail sales taxes are integrated with the GST, the combined rate could approach 20 per cent for some provinces. In this case, an exempt organization could save perhaps 10 per cent of its costs by producing a good or service in-house. It is likely that corporations supplying exempt institutions will object to the partial nature of this rebate. Additional rules are proposed for other tax-exempt activities in order to discourage this "self-supply" bias. For example, developers would be tempted to lease their new buildings directly rather than selling them to a landlord.[12]

Provincial governments are major purchasers of goods and services, and so any self-supply bias would be a serious blow for certain corporations. The *Technical Paper* leaves the treatment of provincial governments as a subject to be negotiated with the provinces. The

Paper notes that under Section 125 of the Constitution Act, 1867, "no lands or property belonging to Canada or any province shall be liable to taxation." In view of this, the *Technical Paper* states that provincial governments will not be subject to GST on their purchases. At the present time, eight provincial governments have signed Reciprocal Taxation Agreements with the federal government in which they "agree not to claim refunds of federal tax to which they are otherwise entitled, and the federal government makes payments, as if it were taxable, of the sales and consumption taxes imposed by the participating provincial governments."[13] With the GST, new agreements will have to be negotiated in regard to the way in which provinces will be relieved of the GST liability on their purchases. The *Technical Paper* takes the position that this subject will have to include three additional issues:

- how to provide parallel treatment for the federal government under the provincial retail sales tax systems;
- the collection of each others' taxes when sales are made by governments to third parties; and
- the status of other taxes and fees currently covered by the Reciprocal Taxation Agreements.

The process for supplying provincial governments with a GST rebate has important compliance cost implications. In particular, point of sale relief through the provision of exemption certificates would require that corporate suppliers maintain detailed records of all sales to governments, so that they may confirm for audit purposes that they did not collect tax on these sales. On the other hand, if provincial governments pay GST at the time of purchase and later claim a federal rebate, then corporate suppliers will not have to maintain these detailed records. It seems that the credit mechanism to provide tax refunds to the provinces is the most sensible approach.

In regard to the self-supply bias, the GST obligation of corporations that provide municipal services will also be an important subject. The Technical Paper notes that "notwithstanding how the service is financed, standard residential services provided by, or on behalf of, municipalities will be tax-exempt."[14] However, it is not clear what the phrase "on behalf of" entails. In particular, corporations may be concerned that this exemption will be interpreted such that some of their activities, like garbage collection, would be taxed while similar activities undertaken by a municipality will not be taxed. It is possible that municipalities could be encouraged by the GST to undertake such activities directly themselves rather than allowing the private sector to undertake them. The *Technical Paper* suggests that an attempt will be made to separate municipal services into two groups, with standard residential services being tax-exempt while others are taxable. It suggests that the division be on the basis of whether the service is optional to individual households on a fee-for-service basis. However, this division will likely result in disagreements and the need for revisions to interpretation bulletins. In a sense, this subject involves the broad question of the appropriate role for government as a producer of goods and services. A related issue is the question of GST rebates on purchases made by municipal governments and other tax-exempt organizations. The *Technical Paper* proposes only a partial rebate of sales tax paid on their purchases, and so the self-supply bias may remain from this perspective as well.[15]

Could an Integrated Tax Allow for Rate Differences Among Provinces?

The reality of Canadian taxation is that current rates and exemptions in regard to sales taxes do vary significantly among provinces. From the perspective of an integrated federal-provincial GST, it is useful to examine the experiences of the EEC. For both Canada and the EEC, the desire to create a more complete economic union has important implications for the design of a value-added tax. Recently, the EEC has been analyzing the processes through which indirect taxation could be made more uniform throughout the European countries. Literature published by the Commission of the European Communities emphasizes that indirect taxation must be made uniform. Otherwise, firms in some countries may be given an unfair competitive advantage. Furthermore, the Commission believes that significant variations in terms and conditions, and rates of indirect taxation, can lead to substantial tax evasion, as customers make their purchases in the lowest tax areas regardless of where they live and work. It is important to note, of course, that one's attitude towards federalism may lead one to support tax differences among provinces. As discussed earlier in this volume, some people may support the right of provinces to impose their own tax designs even if this results in inefficiencies and tax evasion.

Recent documents of the European Council indicate guidelines that do permit some deviation by individual member states. For example, the Council has recommended that certain basic goods and services should be taxed at a reduced rate, namely foodstuffs (with the exception of alcoholic drinks), energy products for heating and lighting, supplies of water, pharmaceutical products, books, newspapers, periodicals, and passenger transport. In addition to imposing this uniformity and reduced rates, the Council has recommended that the reduced rate be restricted to the range of 4 to 9 per cent. It has recommended that the standard rate be restricted to the range of 14 to 20 per cent. The Commission has recommended that no products be zero-rated.[16]

Compliance costs may vary among taxpaying firms to a much greater degree for a GST than they do for the existing federal manufacturers sales tax or the provincial retail sales taxes. In particular, small firms can experience much higher compliance costs than large firms.[17] It should also be noted that differences in integrated rates among provinces would add greatly to compliance costs. Corporations would have to develop a bookkeeping system that would keep track of the province where each of its transactions occurred. Purchases and sales would involve different rates of tax. From this perspective, it will not be enough for businesses to lobby for an integrated GST; they must lobby for an integrated GST with a uniform rate across the country. Without such a uniform GST rate, it is not clear that an integrated GST would mean lower compliance costs than a separate federal GST and provincial retail sales taxes.

5. The Administrative Structure

A large variety of administrative decisions will have to be made, and many questions will arise in the course of implementing a GST. Would an integrated federal-provincial GST be administered by the federal government, in such a way that the revenue immediately flows to Ottawa for subsequent reallocation to the provinces? An alternative is a decentralized but federally coordinated national sales tax, where the provinces collect and retain revenues (on a destination basis), and subsequently issue rebates to the federal government or receive

adjustments. With such an approach, however, it is likely that provinces would tend to undertax their constituents, realizing that the federal government would bear a major portion of any non-collection of taxes. There could be a lack of uniformity in enforcement and collection, together with legal questions about the power of a province to enforce tax collection from those who are not resident within the province.

In spite of the above arguments in favour of federal administration, nevertheless, many provinces may favour a provincial administration. This would make it easier for provinces with high rates to enforce their GST against residents who make purchases in other provinces. Furthermore, it would provide provincial government jobs rather than federal government jobs. In a symbolic way, provincial administration may be seen as a key element in provincial autonomy. Of course, the right of each province to define its own tax base is more important than the right to administer a system whose design features have been decided by the federal government. Countries have made a variety of choices in regard to this issue. It is interesting to note that in Germany the states collect and administer the value-added tax. In Brazil, on the other hand, the federal government administers the tax at the manufacturing stage only, while the states administer the tax at other stages.[18]

Provincial governments have sometimes used their retail sales taxes as a counter-cyclical fiscal mechanism, reducing certain rates in times of recession. In addition, the choices of exemptions and special excise duties have given provincial governments considerable scope for exercising their own judgements in regard to equity considerations. Current federal-provincial tax collection agreements in regard to personal and corporate income taxes already severely limit provincial fiscal autonomy.[19] Integration of retail sales taxes with a GST could remove this last area for independent provincial tax decisions. The need for active provincial involvement in the administration of an integrated GST must be understood in this context. Furthermore, even if the federal government imposes a federal-only GST, the provinces will inevitably regard federal administrative decisions as an incursion upon their traditional practices and a threat to their autonomy.[20]

From this perspective, an important subject will be the creation of a decision-making structure for the series of issues and possible changes that will inevitably arise in the future. It seems unlikely that each province will have the right to make its own decisions in view of the federal government's arguments for uniformity across Canada in regard to the tax base. On the other hand, it is also unlikely that the provinces will be prepared to surrender to the federal government the authority to make any changes it wishes. Consequently, it is likely that some kind of joint decision-making structure will have to be chosen. This structure could take any one of a large variety of forms, with any one of a variety of voting rights.

Satya Poddar has discussed a number of administrative design details in his article, "Issues in Integration of Federal and Provincial Sales Taxes: A Canadian Perspective." In particular, Poddar notes that there could be significant administrative savings through combining the information and audits for income tax with the information and audits for the GST. Poddar emphasizes the personnel difficulties in merging the federal GST administration with provincial retail sales tax administration, including the questions of relative pay scales and hierarchy. The precise division of auditing, collection, and verification responsibilities would be important from this perspective. Poddar has also emphasized the constitutional perspective. Provincial governments can only impose a "direct tax" on their residents. A retail sales tax is considered a direct tax, but a GST might not be considered a direct tax. To

integrate a federal and a provincial GST, administrative procedures would have to be developed in conformity with constitutional requirements.

> To overcome these constraints it is proposed that the provinces would impose their tax on only the final consumer sales. An equivalent tax on all other intermediate transactions would be imposed under a federal statute. The federal government would thus impose a federal tax on all transactions at a uniform national rate and a "provincial" tax on all transactions, excluding sales to final consumers, at rates equivalent to those set by the provinces under their own statutes. This mechanism does not yield any additional revenues to the federal government as all taxes collected at intermediate levels are offset by equivalent matching input tax credits.
>
> The federal government could have imposed the "provincial" tax on all transactions, including the final sales to consumers, and then entered into a revenue transfer agreement with the provinces. This option would not have been as appealing to provinces, as it implied their abdicating this tax field entirely, at least legislatively.[21]

6. Issues To Be Decided Within Each Province

The Provincial GST Rate

If a province eliminates its retail sales tax and becomes a part of an integrated GST, a key issue will be the provincial rate to be added onto the federal rate. An important question will be the revenue estimates for alternative provincial GST rates. Another important question will be the choice of increases in alternative taxes if the GST revenue will be less than the current RST revenue. The need to increase other taxes could be especially pressing if the other provinces' decisions about provincial rates lead to a situation where a certain province's GST rate is too low to raise adequate revenue to replace its current retail sales tax revenue. These issues may require a major tax review in each province, particularly if it is necessary to raise alternative taxes.

Provincial Income Tax Credits

An integrated GST may take more tax from low-income people than the combination of federal manufacturers sales tax and provincial retail sales taxes do. For each province, an important question will be whether a provincial sales tax credit should also be provided on the income tax return, and if so, what level and type of credit should be provided. For low-income people, the timing of income tax rebates is extremely important, whether they should be annual, monthly, or weekly. The need may exist to base the current year's rebate on the previous year's tax return. Each province will wish to resolve a number of such issues.

Forecasting Provincial Revenues

The process for forecasting provincial revenue may be made more difficult and more imprecise if the province becomes part of the GST. In particular, a province may have to rely upon

forecasts developed by the federal government. Consequently, provinces may wish to develop new national mechanisms for forecasting their revenues with the GST.

Retention of a Provincial RST

If a province retains its retail sales tax while other provinces join, then it will have to consider eliminating its provincial retail sales tax on business inputs. Firms in a province that retains its sales tax will compete with firms in other provinces where the GST will have eliminated taxes on business inputs. Consequently, firms will likely exert political pressure to alter the retail sales tax in this way. Otherwise, firms operating under the GST may have a tax advantage, particularly if they export and receive a full rebate of all GST paid on inputs.

A New Distribution of the Total Tax Burden

The GST and the Canada-U.S. free trade agreement will combine to shift the tax burden. Some firms will win considerably as a result of these two major changes, while some firms will lose. Some individuals will win considerably, while other individuals will lose. For Canadian firms that export, these two new developments may offer considerable advantages. As a result of these changes in relative financial position, provinces will have to consider their overall tax structures for firms and individuals who are in different financial positions. For example, it may be considered appropriate to raise royalties on natural resources because, otherwise, the benefits of the GST exemption for business inputs and exports may go largely to workers and shareholders in the natural resource sector. It is important to note that the elimination of the MST will not affect all firms equally. Furthermore, the inclusion of services under a GST will significantly alter the sharing of the tax burden. It is unclear at this point whether the exemptions and income tax credits accompanying a GST will alter the progressivity of the tax structure for individuals. This subject will also have to be considered by each province in deciding upon its new tax structure.

7. Conclusion

Federal-provincial GST negotiations are an important crossroads for fiscal federalism. Many of the issues involved with the GST will arouse considerable lobbying from certain groups of consumers and firms. With a new GST, some corporations and individuals stand to benefit considerably, while others will lose considerably. Overall, there will no doubt be a significant reduction in economic distortions and a significant improvement in Canadian international competitiveness. Nevertheless, the negotiation process will be complex and lengthy. In the past, federal-provincial negotiations concerning the personal and corporate income tax have sometimes failed to coordinate tax bases and collection procedures, resulting in what has been referred to as a *tax jungle*. Hopefully, negotiations can avoid the creation of a new tax jungle with the GST. Of particular significance, is the definition of the tax base. A greater federal government sensitivity to political realities will be required in order to reach trade-offs and compromises acceptable to the provincial governments.

Notes

1. See, for example, the comments of the President of the Retail Council of Canada and the President of the Canadian Federation of Independent Business in Joydeep Mukherji and Margaret Philp, "Tax Termed a Welcome Change Despite Flaws," *The Globe and Mail*, 9 August 1989, p. B1, and Drew Fagan, "New Tax Has Interest Groups Snarling," *The Globe and Mail*, 7 August 1989, p. B2.

2. Michael H. Wilson, *Tax Reform 1987: Sales Tax Reform* (Ottawa: Department of Finance, 1987), pp. 9-24.

3. *Ibid.*, pp. 25-28.

4. Under the current equalization formula, "an increase in a province's tax rates will increase own revenues and, if the province is poor for this tax base, also increase equalization. For any other province, equalization entitlements will increase if the province is a 'have-not' province for this tax base, and vice versa." This point is discussed more fully in Chapter X.

   Thomas J. Courchene, *Equalization Payments: Past, Present and Future*, Ontario Economic Council Special Research Report, 1984, p. 356.

5. Dieter Pohmer, "Germany," *The Value-Added Tax: Lessons from Europe*, ed. Henry J. Aaron (Washington, D.C.: The Brookings Institution, 1981), p. 99.

6. See for example, Richard Watson, "There's more to tax than Martelange," *Euromoney* (1988), pp. 17-19.

   See also Marko Ros and Hans Nelson, "Indirect Taxation and the Completion of the Internal Market of the EC," *Journal of Common Market Studies* 27 (1988), pp. 27-44.

7. Sijbren Cnossen, Discussion of Satya Poddar: "Issues in Integration of Federal and Provincial Sales Taxes: A Canadian Perspective," and David E. Wildasin, "The (Apparent) Demise of Sales Tax Deductibility: Issues for Analysis and Policy," *The National Tax Journal* 41 (September 1988), p. 392.

8. *Ibid.*, p. 393.

9. Michael H. Wilson, *Goods and Services Tax Technical Paper* (Ottawa: Department of Finance, 1989), p. 13.

10. See for example, Watson, pp. 17-19.

11. Wilson, p. 122.

12. *Ibid.*, p. 114.

13. *Ibid.*, p. 135.

14. *Ibid.*, p. 134.

15. *Ibid.*, p. 137.

16. Commission of the European Communities, *Completion of the Internal Market: Approximation of Indirect Tax Rates and Harmonization of Indirect Tax Structure* (Brussels: Commission of the European Communities, 1987).

17. C.T. Standford, M.R. Godwin, P.J.W. Hardwick, and M.I. Butterworth, *Costs and Benefits of VAT* (London: Heinemann Educational Books, 1981), p. 51.

18. See for example, Alan A. Tait, *Value Added Tax: International Practice and Problems* (Washington, D.C.: International Monetary Fund, 1988), pp. 155-171.

19. See for example, A.J. Robinson, *The Retail Sales Tax in Canada*, Canadian Tax Papers, No. 77 (Toronto: Canadian Tax Foundation, 1986).

20. See Jacques Parizeau, "Implications of Tax Reform for Federal-Provincial Relations," in *Report of the Proceedings of the Thirty-Ninth Tax Conference* (Toronto: Canadian Tax Foundation, 1987).

21. Satya Poddar, "Issues in Integration of Federal and Provincial Sales Taxes: A Canadian Perspective," *The National Tax Journal* 41 (September 1988), pp. 376-378.

PART IV

CONCLUSION

Chapter XIII

Concluding Comments

Our purpose in this book has been to evaluate tax reform options facing Canada's provinces. Apart from the detailed analyses of particular alternatives, several basic themes deserve emphasis.

Tax reforms may be advocated as a way of pursuing a number of different objectives. However, tax reforms can frequently involve trade-offs, with the sacrifice of one objective in order to attain another objective more fully. A society's attitude towards these trade-offs may change over time. Apart from changes in political philosophy, changing economic realities may lead a society to place a heavier emphasis on a particular objective than it has in the past. For example, some provinces have experienced persistently high unemployment rates, and for them the attainment of economic growth and job creation may be a more important objective than it is for provinces with low unemployment rates. Consequently, the choice of a certain tax mix may be inappropriate during another time period or for other provinces. Furthermore, the nature and extent of distortions and inefficiencies caused by a certain tax mix can only be ascertained through the practical implementation of that tax mix. Predictions involve considerable uncertainty. In many cases, today's analytical techniques are unable to measure tax reform impacts with much precision even after these reforms have been implemented. In particular, the shifting of taxes can mean that economic incidence may be quite different from statutory incidence. From these perspectives, it can be seen that the preferences of one province in regard to tax structure may differ considerably from the preferences of another province.

It is helpful to understand that a central mechanism for achieving tax reform is simply to place a different degree of reliance on the alternative types of taxes. By changing tax rates, a province can significantly alter its tax structure and the degree of progressivity of that structure without having to change the design of any of its taxes. Each tax has its own

incidence impacts, and each tax is different in regard to the attainment of society's objectives. In fact, as we examine the current tax structures of Canada's provinces we find significant differences in tax mix among the provinces. Consequently, the opportunity to alter its tax mix provides each province with considerable scope for tax reform.

With the personal income tax and the corporate income tax, provinces have the opportunity simply to levy their tax as a percentage of the federal tax. This opportunity minimizes provincial administrative costs and minimizes compliance costs of individuals and corporations within the province. However, this approach by a provincial government eliminates most tax reform options in these fields. The province is required to accept the federal government's regulations, interpretations, exemptions and deductions, and the province cannot take the initiative in reforming the design of these taxes. Over the coming years, a major issue will concern possible modifications in the federal-provincial tax collection agreements that could permit provinces to levy their tax on the base as defined by the federal government. This would enable each province to decide upon its own specific set of exemptions and deductions.

The most important tax that remains completely under provincial control at this point in time is the retail sales tax. In view of this, provincial tax reform discussions must devote considerable attention to the design of the retail sales tax. In particular, provinces have made widely differing choices in regard to exemptions and rates. The possible impact of these exemptions is of crucial importance for provincial taxation. The progressivity or regressivity of this tax may be altered considerably through the provision of certain exemptions. It has also been emphasized that in practice, provincial retail sales taxes are imposed on many business inputs and investment goods. The degree to which this occurs varies considerably among goods and services. As a result, provincial retail sales taxes involve tax cascading that can severely distort relative prices. Even if provinces refuse to join a new national sales tax, these design issues for the retail sales tax will remain of crucial importance for provincial tax reform.

Provinces have relied, to varying degrees, on a large number of factor specific taxes. The choice and design of these taxes will also be of great importance. In particular, the use of payroll taxes and capital taxes will receive attention. Payroll taxes can be seen as related to certain government benefits, and some may advocate an expansion of payroll taxes for this reason. Capital taxes can be seen as a way of taxing certain corporations that may contribute relatively little through the corporate income tax. A main advantage of the capital tax is that it is deductible against federal corporate income tax payable, and so a province levying a capital tax effectively compels the federal government to bear a portion of this tax.

Among factor specific taxes, various forms of resource taxation will remain the focus for reform debate. Apart from direct taxation, provincial governments can collect revenue through royalties, competitive bidding, marketing boards, and public ownership. The choice of preferred technique is likely to vary from one resource to another, and also over time. Consequently, we may expect that resource taxation will be in a state of constant change.

Property taxation involves each province in the politics of municipal finance. Reform of property taxes will not affect all of a province's municipalities equally, and so property tax reform is likely to remain a contentious issue. Reform of the property tax is likely to centre upon three issues: (1) whether the property tax can and should be used as a benefits-related tax; (2) whether the incidence of the property tax is regressive and whether the society's choice

should be influenced by such regressivity; and (3) whether effective rate differentials cause unacceptable distortions.

Since 1957, equalization payments from the federal government to certain provinces have been based upon a formula. This formula has compared the revenue potential of specific tax rates when applied to each province's tax base on the one hand, with the revenue potential of those tax rates when applied to the average tax base of certain other provinces. Originally, the revenue potential of the two richest provinces was the standard for the comparison. Then the national average was the standard, and currently five representative provinces are the standard. The number of taxes included in the formula has expanded from three in 1957 to 32 in 1982. Of particular importance has been the treatment of resource rents, and this treatment has changed significantly from time to time.

For the recipients of equalization payments, the impact of any possible reform options on the dollar volume of their equalization payment is a crucial issue. For the provinces which have relatively few resources, equalization payments can be seen as a mechanism for sharing the good fortune of resource-rich provinces. We can expect that the price of resource-based products will oscillate over time, that new resource deposits will be discovered, and that some existing deposits will be depleted. From this perspective, we may expect that the volume of equalization payments received by a province may change over time quite apart from changes in the formula itself.

With its 1987 White Paper on Tax Reform, the federal government began a substantial and lengthy process that has automatically impacted the tax structure of the provinces. By removing specific preferences, broadening the tax base, lowering tax rates, and replacing exemptions with tax credits, the government has sought to increase incentives to work and invest, to remove obstacles to growth and job creation, and assure that the tax burden will be distributed more equitably. These unilateral changes by the federal government have emphasized that the tax collection agreements must be altered if provinces are to have much scope for independent choices in regard to the personal and corporate income taxes. Otherwise, federal tax reform will automatically mean provincial tax reform.

We have placed considerable emphasis throughout this book on the federal government's new national sales tax because it raises the most important tax reform choice facing the provinces in the next few years: whether to eliminate their provincial retail sales taxes and to join in a new federal-provincial sales tax. We have emphasized that this decision must be based upon the negotiation of many issues which will be impacted by such a decision. This question cannot be analyzed quickly or easily. It will require substantial discussion with detailed analyses of alternative tax designs. Consequently, it is likely to remain as an important provincial tax reform possibility for a number of years.

These perspectives emphasize that provincial tax reform will be an ongoing continual process. Each province's preferences, in regard to choices amongst trade-offs, will vary over time. Changes in economic circumstances will alter the relative desirability of alternative tax structures. Relationships with the federal government will likely change, requiring provincial adjustments, and perhaps opening up new tax reform options. In the analysis and evaluation of alternative tax reform options, each provincial government has the right and responsibility to develop its choices on the basis of the wishes of its own residents. Nevertheless, this book has emphasized that the small open nature of provincial economies serves, in practice, as a constraint on these tax reform options. The practical choices facing

each province will be limited by the choices of the other provincial governments. Provincial tax reform then must be not only a matter of individual provincial decisions, but it must also involve interprovincial discussions and negotiations. We conclude with an important question facing our provincial governments: whether interprovincial discussions and negotiations can be conducted satisfactorily on the basis of *ad hoc* meetings and conferences, or whether a permanent interprovincial structure and mechanics should be established to facilitate this process.

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Provincial Tax Reforms: Options and Opportunities

by David W. Conklin and France St-Hilaire

The 1987-1990 federal tax reforms have automatically altered provincial tax systems, and so the provincial governments will now have to reconsider their tax systems from the perspective of possible provincial reforms. In particular, the new federal intrusion into retail sales taxation, through the Goods and Services Tax (GST), will require a re-examination by each province of its own retail sales tax. Furthermore, provinces will have to make a decision as to whether they should join the federal GST system and eliminate their current retail sales tax. In the context of these extensive federal reforms, this book is intended to provide a fresh look at provincial tax reform options and opportunities.

An important subject for Canadian provinces is whether their tax systems should be harmonized, with similar if not identical tax mixes and tax provisions. In view of significant differences in economic circumstances, some provinces may place a greater emphasis on a particular objective, such as employment or economic growth, than would other provinces. Substantial differences do currently exist in regard to tax mix, and these indicate the large scope for provincial tax reform that can be achieved simply by changing the relative weight that provinces place on the alternative types of taxes. This book charts the balance between competitive independence based on provincial differences, on the one hand, and on the other hand, the need to avoid a confusing and perhaps destructive "tax jungle".

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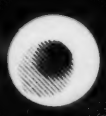

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